ANNUAL REPORT FISCAL YEAR 1999

PUTTING SERVICE FIRST

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

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Internal Revenue Service

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MISSION STATEMENT

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

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MESSAGE FROM THE COMMISSIONER

February 25, 2000

With the enactment of the landmark Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), the IRS embarked on the most comprehensive modernization of the Agency in almost 50 years, focusing on improving service to taxpayers and strengthening taxpayers rights while still processing over 200 million returns and collecting approximately $1.9 trillion.

The individual provisions of RRA 98 are extremely important, but the Act as a whole said something even more important. It told the IRS that it must fundamentally change direction. We must not only collect taxes that are due, but we must think of our job as serving the people who are paying the taxes, America's taxpayers.

I firmly believe we can have a tax agency that does a far better job across the board in achieving all aspects of our new mission: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

To carry out our new mission statement, we proposed three strategic goals to guide us. The first is to provide top quality service to each taxpayer, one at a time. Our second strategic goal is service to all taxpayers collectively so that the few taxpayers who do not pay their taxes are not allowed to add to the burden of those who do. Our third strategic goal is to increase productivity by providing a quality work environment for our employees.

One of the most important steps we have taken in our modernization plan is to make clear that we must achieve all three objectives, not just one or the other, to succeed. We cannot be successful if we collect taxes while providing poor service to taxpayers, nor is the reverse true. Customer satisfaction is not achieved by a failure to collect taxes that are properly due. In addition, we cannot be successful if we cannot find ways to use our limited resources productively or give our employees the proper tools and training.

However, we will not succeed in achieving all three strategic goals without tackling the structural issues that stand in the way of good service and effective operations. We must revamp the way we actually go about doing business to take advantage of new technology and modern and well-established business practices and strategies.

Our decades-old technology is a major stumbling block to the IRS providing adequate service and efficient tax administration, including strong financial management. The General Accounting Office has correctly and repeatedly raised significant concerns and identified substantial weaknesses and deficiencies that prevented the IRS from reliably reporting on several of its required principal financial statements.

The core data systems that the IRS uses to keep records on taxpayers' tax accounts are a serious, on-going risk and barrier to the IRS achieving its strategic goals. They are built on a 30-year old fundamentally deficient foundation. Simply put, the IRS cannot provide reliable taxpayer account and financial information to manage the Agency.

While we are pleased that we received from the GAO an "unqualified" (clean) opinion on the IRS Statement of Custodial Activity, we are obviously disappointed that this past year we did not receive an unqualified opinion on the remaining statements. In addition, what progress we made was due largely to improving labor intensive procedures and until we are able to replace the archaic legacy data systems now in use, we must perfect and continue to use these procedures. There is, unfortunately, no other alternative.

Updating our business practices to better serve taxpayers and be more efficient in collecting taxes will require that the IRS replace nearly its entire inventory of computer applications and convert its data on every taxpayer to new systems. While technology modernization is essential, it is by its very nature, size and complexity risky. In fact, there is no way to avoid risk. However, we are not repeating past mistakes. We are prudently and carefully managing the process, providing for a careful review and external validation of each and every part of the program and making necessary adjustments.

On December 9, 1998, the IRS awarded a Prime Systems Integration Services Contract to Computer Sciences Corporation and their partners to help begin the long process of modernizing IRS' core business and technology systems. We also received from the Appropriations Committees authorization for the release of funds from the Information Technology Investment Account.

This is a first installment toward developing a new set of computer systems and a significant financial investment in our overall modernization plan. With this money, we can continue to roll out improvements for the 2001 filing season. Some of these include enhancing our customer service call-management capabilities, improving electronic tax administration, and upgrading systems security.

Within the IRS itself and in other private and public sector organizations, there are also innumerable successful examples of how we can improve our way of doing business. These improvements, both short- and long-term, hold out the prospect of advancing all three of our strategic goals to a great degree but often depend on making investments in organization, training and technology.

However, short-term service improvements barely scratch the surface of what we need to do. Taxpayers need and deserve service that is tailored to their special needs. Our compliance operation can be most effective by focusing limited resources where they will do the most good. That service must also be managed by people who understand their problems and work every day to reduce their tax administration burden.

Therefore, we have developed a comprehensive plan for organizing the IRS into four customer-focused operating divisions: (1) Wage and Investment; (2) Small Business/Self Employed; (3) Large and Mid-size Business; and (4) Tax Exempt and Government Entities. This reorganization into customer focused units will increase accountability and provide the basis for continued improvements in both service to taxpayers and compliance. This concept gives us the opportunity to make the biggest improvements in the way we serve taxpayers than has been seen in decades.

In the long-term, the best solution to the IRS' fundamental problems, and the best way to meet the expectations of the Restructuring Act and America's taxpayers, is through the massive change program now underway. It will take years and significant and assured resources to address completely the underlying problems in both technology and organization that caused the problems to accumulate over the years. However, with the continued support of the Congress and an understanding of the time and resources it will take to solve this problem, I believe we can succeed.

Sincerely,

Charles O. Rossotti

MESSAGE FROM THE ACTING CHIEF FINANCIAL OFFICER

February 25, 2000

The Internal Revenue Service (IRS) Annual Report for Fiscal Year 1999, as required by the Government Management Reform Act of 1994, consolidates, in one document, information that was previously distributed in separate reports.

I am pleased to report once again that the IRS received an "unqualified" (clean) audit opinion from the General Accounting Office (GAO) on its Statement of Custodial Activity. This is the part of IRS work to account for $1.9 trillion in tax revenues and $185 billion in refunds to taxpayers. On the other hand, our Balance Sheet received a qualified opinion. GAO said that "Except for limitations on the scope of our work resulting from insufficient evidence about the reliability of the components of net position in Note 11, the balance sheet including the accompanying notes present fairly in all material respects, in conformity with generally accepted accounting principles, IRS' assets, liabilities, and net position as of September 30, 1999." While the IRS hoped to have an unqualified opinion on the Balance Sheet, we have renewed our efforts for FY 2000.

The IRS also reported a number of items as material weaknesses/non-conformances through the Federal Managers' Financial Integrity Act (FMFIA) reporting process. These and other financial management issues are more fully discussed in the IRS Management Representation Letter and our comments under Management Challenges.

To effectively address these matters, the IRS has formed a Financial and Management Controls (FMC) Executive Steering Committee (ESC). The primary scope of the FMC ESC is to develop a strategy for earning a clean opinion from GAO's audit of IRS' financial statements and to address the material weaknesses and national control deficiencies as self-reported through the FMFIA process. This committee is comprised of IRS executives who possess extensive experience in finance, operations, systems, communications, and law. Members are also drawn from the Department of Treasury as well as the National Treasury Employees Union.

All of the CFO staff and other IRS employees worked diligently to make improvements during FY 1999 in the following areas: overall financial reporting; accounts payable records; amounts held in suspense accounts; documentation of unpaid assessments; reconciliation of fund balances with Treasury; computer security; and, handling of taxpayer receipts and data, including courier security.

We have set our goals to improve our statements while also working to develop the long-term solutions for an integrated financial management system.

Lawrence W. Rogers

MODERNIZING THE IRS - GOALS, PRINCIPLES, AND CHANGE

"We must succeed on all these fronts to make modernization a success."
Charles Rossotti, Commissioner, Internal Revenue Service

Serving taxpayers better is the key concept behind everything the IRS is doing to modernize. The importance of service is reflected in three goals:

Service to each taxpayer
Service to all taxpayers
Productivity through a quality work environment

Five guiding principles help show the way through modernization. These guiding principles allow the IRS to manage both the organizational change and the operations and maintenance that must continue during the rebuilding process. The guiding principles are:

Understand and solve problems from taxpayer's point of view
Expect managers to be accountable
Use balanced measures of performance
Foster open, honest communication
Insist on total integrity

Finally, there are five equally important, critical areas of change:

Revamped business practices
Organizing the IRS into four operating divisions
Developing management roles with clear responsibility
Adopting a balanced measurement of performance
Implementing new technology

The IRS strategy pyramid can be seen in Exhibit 1.

AGENCY PROFILE

ORGANIZATION

To help understand the current IRS organization, the primary functions of each organizational component are described below. A detailed organizational chart showing the Service's current structure can be seen in Exhibit 2. These offices are in the process of changing their roles and/or functions as the IRS restructures itself to implement the Commissioner's modernization plan (Exhibit 3).

NATIONAL OFFICE

The Commissioner of Internal Revenue, appointed by the President and confirmed by the Senate, is the head of the IRS. The National Office in Washington, DC develops broad national policies and programs for the administration of tax laws and regulations, and evaluates programs for accomplishment of strategic objectives.

REGIONAL OFFICES

The four regional offices oversee broad national plans and policies, and coordinate, direct, and review operations of the districts within their regions. They also perform evaluations of programs under their jurisdiction.

DISTRICT OFFICES

The 33 district offices conduct the Examination, Collection, and Criminal Investigation functions of the Service within an established geographic area. Districts also identify areas of noncompliance through expanded, market-oriented research. They focus appropriate resources on bringing taxpayers into compliance through strategies centered around education, outreach, and enforcement. The district offices provide various personal, or face-to-face, taxpayer services such as taxpayer education, walk-in assistance with tax account concerns, and on-site distribution of tax forms. District offices also manage two volunteer programs: Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). As a part of these programs, district employees recruit, select, and train volunteers to assist taxpayers in completing tax forms.

SERVICE CENTERS

The ten service centers are the data processing arm of the IRS. The centers process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

Each year, the service centers process millions of tax returns and related documents. The service centers report to the Executive Officer for Service Center Operations (EOSCO).

CUSTOMER SERVICE SITES

These 24 sites will consolidate customer service responsibilities previously distributed among service centers, automated collection system sites, taxpayer service toll-free sites, and other toll-free operations. They will provide one-stop telephone and correspondence service to taxpayers by answering questions, providing assistance, and resolving compliance and other account-related issues.

COMPUTING CENTERS

The Martinsburg Computing Center, the Detroit Computing Center, and the Memphis Computing Center support IRS tax processing and information management through a data processing and telecommunications infrastructure. They eventually will receive all electronically–filed tax returns and payments, maintain tax account and related case data, and provide users at other IRS sites on-line access to the data.

ADMINISTRATIVE SERVICES CENTER

This facility provides centralized administrative payments and certain accounting functions which were previously performed by national/regional office staff. In the near future, it will also be providing similar services for our districts and service centers.

EXHIBIT 1 IRS STRATEGY PYRAMID

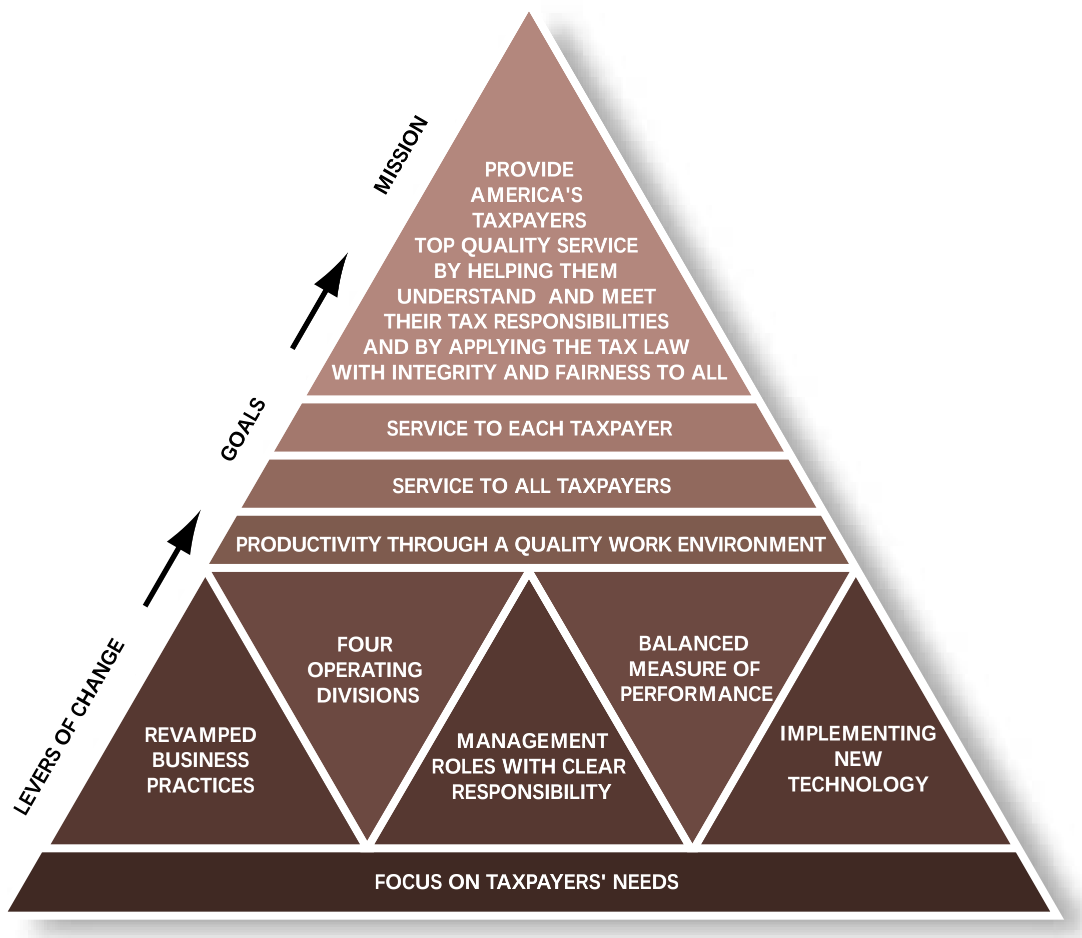
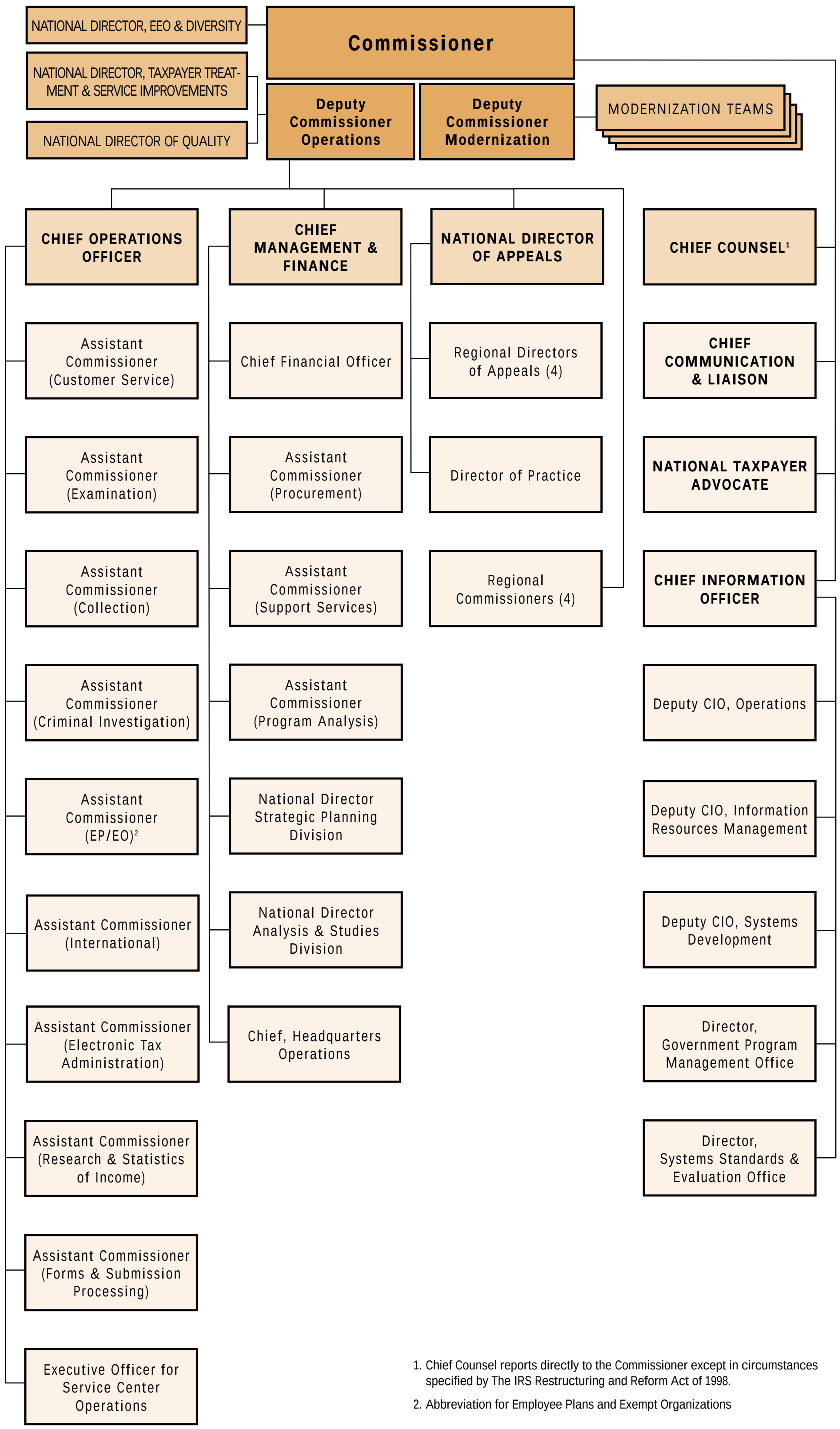


EXHIBIT 2

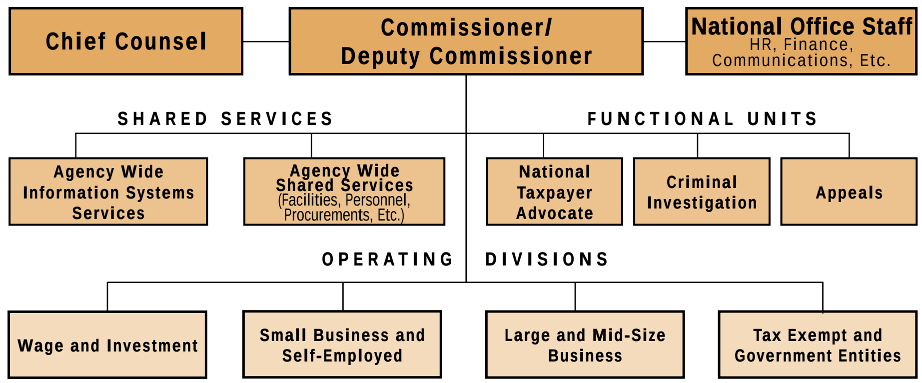
Current Organizational Structure



1. Chief Counsel reports directly to the Commissioner except in circumstances specified by The IRS Restructuring and Reform Act of 1998.
2. Abbreviation for Employee Plans and Exempt Organizations

Exhibit 3

New Organizational Structure



HIGH IMPACT AGENCY GOALS (1)

The IRS is reporting its performance against the goals shown in Exhibit 4. These goals are part of the FY 2001 OMB Submission published September 13, 1999. These management level goals are intended to report on the IRS' overall performance in delivering on its mission and goals. In the IRS' future organizational structure, strategic measures will also be applicable for each of its four major operating divisions.

Immediately following Exhibit 4, a brief explanation of what each performance goal is designed to measure is provided. In addition, an explanatory narrative is also provided into the causes of significant variances in performance between plan, actual, and prior year results. Since the IRS is in the process of developing procedures and requirements for the verification and validation of its High Impact Agency Goals, the reader should use prudence in making assessments or drawing conclusions from them.

EXHIBIT 4

	GOALS	FY 99 Plan	FY 99 Actual	FY 98 Actual
1.	Toll-Free Level of Service **(2)**	**(3)** Baseline	53.3%	**(4)** 70%
2.	Tax Law Accuracy Rate for Taxpayer Inquiries (Toll-Free)	**(5)**85%	74.1%	93.8%
3.	Refund Timeliness - Paper (%)	**(6)** Baseline	83.2%	**(7)** 85.5%
4.	Refund Timeliness - e-file (%)	98%	99.6%	98.7%
5.	Number of Individual Returns filed through Electronic Return Originators (EROs) (millions)	20.9	21.2	17.7
6.	Number of TeleFile Returns (millions)	6.6	5.7	5.96
7.	Number of Eligible Quarterly Forms (Form 941) filed through TeleFile (thousands)**(8)**	1,146.1	915.7	518.9
8.	Customer Satisfaction **(9)**			
	a. Toll-Free	Baseline	6.2	N/A
	b. Automated Collection System	Baseline	5.9	N/A
	c. Service Center Examination	Baseline	3.9	N/A
	d. Field and Office Examination	Baseline	4.1	N/A
	e. Appeals	Baseline	4.44	N/A
	f. Field Collection	Baseline	3.9	N/A
	g. Walk–In	Baseline	6.4	N/A
	h. EO Determination	Baseline	5.3	N/A
	i. EP Determination	Baseline	5.5	N/A
	j. EO Examination	Baseline	5.5	N/A
	k. EP Examination	Baseline	5.4	N/A

Footnotes

(1) As noted above, the performance information presented in this section as "goals" was part of the FY 2001 OMB Budget Submission. The subsequent Congressional Budget Justification renamed these goals as, "IRS Measures Related to High Impact Agency Goals" and will be referred to as such in future reports.
(2) This measure has been changed from Level of Access to Level of Service.
(3) Toll Free Level of Service –FY 1999 was listed as a baseline year in the FY 2000 Congressional Justification because this is a quantity measure. The Regulation concerning the use of quantity measures was not issued until September 1999.
(4) The FY 1998 performance is included for comparison purposes.
(5) Starting in FY 1999, Tax Law Accuracy has been generated by the Centralized Quality Review System (CQRS), a more comprehensive quality review system than the Integrated Test Call Survey System (ITCSS) used in prior years. CORS results are more indicative of the quality of IRS response to tax law inquiries than the ITCSS. CQRS reviews are performed on live taxpayer inquiries in their entirety; ITCSS was designed to test only one aspect of a tax law topic.
(6) The methodology for calculating this measure changed in the first quarter of FY 1999,therefore, the FY 2000 Congressional Justification showed FY 1999 to be the "Baseline" year.
(7) The FY 1998 results were recalculated for comparison purposes.
(8) This measure reflects fiscal year numbers for all years except for the FY 1999 Plan, which was a calendar year projection.
(9) All scores are on a 7 point scale with "1" being very dissatisfied and "7" being very satisfied and are based on surveys of calendar year 1998 activities.
N/A: Not Applicable

HIGH IMPACT AGENCY GOALS EXPLANATIONS

1. *(Toll-Free) - Level of Service*

Level of Service provides information about how many taxpayer calls are answered by an assistor. It addresses the IRS mission of providing top quality service to America's taxpayers, supports the strategic goal *Service to all taxpayers*, and supports the IRS commitment to make filing easier by answering taxpayers' questions concerning their income tax returns, providing assistance with their tax returns and accounts, and providing professional and helpful treatment in cases where additional taxes may be due. Level of Service, as a business results measure, is one of the components of the Balanced Performance Measurement System. Using measures of customer satisfaction and employee satisfaction with this measure allows the IRS to use quantity data to identify training needs and to make appropriate changes to procedures.

2. *Tax Law Accuracy Rate for Taxpayer Inquiries (Toll-Free)*

This measure provides an evaluation of the accuracy of IRS' responses to taxpayer questions concerning tax law. It supports the IRS mission of providing top quality service to America's taxpayers and, in particular, the strategic goal *Service to all taxpayers* and reflects the IRS commitment to provide top quality service to each taxpayer. Accuracy, as a business results quality measure, is one of the components of the Balanced Performance Measurement System. Using this measure along with customer satisfaction and employee satisfaction allows the IRS to use quantity data to identify training needs and to make appropriate changes to procedures.

3. *Refund Timeliness - Paper (%)*

This measure evaluates the ability of the IRS to issue refunds for paper filed individual returns timely. A timely issued refund is one issued in 40 days or less from the signature date of the return. This measure addresses the IRS mission of providing top quality service to America's taxpayers. More specifically, it supports the strategic goal "Service to all taxpayers" and it shows that IRS takes seriously its responsibility to provide quality service to taxpayers and to ensure that taxpayers receive their refunds of overpayment of income taxes in less than 6 weeks of filing their returns.

4. *Refund Timeliness - e-file (%)*

This measure evaluates the ability of IRS to issue refunds for electronically filed individual returns in a timely manner. A refund, timely issued, is one processed in less than 21 days after the date the electronically filed return is accepted. This measure addresses the IRS mission of providing quality service to America's taxpayers. More specifically, it supports the strategic goal "Service to all taxpayers" and it shows that the IRS takes seriously its responsibility to provide top quality e-file products and services that benefit taxpayers.

5. *Number of Individual Returns filed through Electronic Return Originators (EROs)*

This measure identifies the total number of individual returns that are filed electronically through Electronic Return Originators (EROs). It supports the strategic goal "Service to all taxpayers" and addresses opportunities for taxpayers who use the services of a paid preparer to file electronically. It allows the IRS to measure the effectiveness of its marketing and advertising initiatives to increase taxpayer awareness of e-file options as well as our efforts to increase the number of EROs who are participating in the IRS e-file program. It also helps the IRS evaluate our progress in meeting the Congressional goals for electronic filing reflected in Restructuring and Reform Act of 1998 (RRA 98).

6. *Number of TeleFile Returns*

This measure identifies the total number of individual tax returns filed using a touch-tone telephone to reach the TeleFile system. It addresses the IRS mission of providing top quality service to taxpayers and supports the strategic goal "Service to all taxpayers" by providing alternative methods of filing and making filing easier for many individuals. It also helps the IRS evaluate our progress in meeting the Congressional goals for electronic filing reflected in RRA 98.

7. *Number of Eligible Quarterly Forms (Form 941) filed through TeleFile*

This measure shows the total number of Forms 941 from eligible businesses (approximately 3.3 million Tax Packages are mailed per quarter) filed through TeleFile. The measure addresses the IRS mission of providing top quality service to taxpayers and supports the strategic goal "Service to all taxpayers" by providing alternative methods of filing and making filing easier for many businesses. It also helps the IRS evaluate our progress in meeting the Congressional goals for electronic filing reflected in RRA 98.

8. *Customer Satisfaction*

These measures provide information about how taxpayers rate their overall satisfaction with the service they receive from the IRS. They address the IRS mission of providing top quality service to America's taxpayers. The Customer Satisfaction measure supports the strategic goal "Service to each taxpayer" and reflect the IRS commitment to make filing easier by answering taxpayers' questions concerning their income tax returns and to provide prompt, professional assistance with their tax returns and accounts. Customer Satisfaction is one of the components of the Balanced Performance Measurement System. Using these measures along with business results and employee satisfaction allows the IRS to use direct customer feedback to identify taxpayer needs and to make changes in procedures/services.

HIGH IMPACT AGENCY GOALS PERFORMANCE ANALYSIS

TAX LAW ACCURACY RATE FOR TAXPAYER INQUIRIES (TOLL-FREE)

The decline in FY 1999 performance from the plan and the prior year is primarily attributable to new, less experienced employees who were hired to meet the expanded 7 day week, 24 hours per day schedule of operations. In addition, revised procedures were required to accommodate tax law changes.

REFUND TIMELINESS - PAPER

The decline in FY 1999 performance from the prior year is primarily due to the transshipment of tax returns from one understaffed Service Center (created by the strong local economy) to those with more optimal employment levels. This increased the time needed to process the affected returns and issue refunds.

REFUND TIMELINESS - E-FILE

The improvement in FY 1999 performance over the plan and the prior year resulted from a general increase in processing efficiency.

NUMBER OF INDIVIDUAL RETURNS FILED THROUGH ELECTRONIC RETURN ORIGINATORS (EROs)

The improvement in FY 1999 performance over the plan and the prior year is attributable to IRS marketing and advertising initiatives designed to increase taxpayers awareness of e-file options. In addition, IRS sponsored tax forums favorably affected the number of EROs who participated in the e-file program.

NUMBER OF TELEFILE RETURNS

The decline in FY 1999 performance from the plan and the prior year resulted from the impact of tax law changes (e.g., Lifetime Credit for Students and Hope Scholarship Credits) and the shift to on-line filing that occurred during the 1999 filing season. Taxpayers who claimed the lifetime credit for students and Hope Scholarship Credits were no longer eligible to file through Telefile.

PROGRAMMATIC HIGHLIGHTS

MODERNIZING THE IRS

Aggressive work to modernize the IRS continued in 1999. The need to change the IRS had culminated in passage of the RRA 98, which in turn, resulted in the development of a new mission statement for the IRS. That mission was translated into three goals: service to each taxpayer, service to all taxpayers, and productivity through a quality work environment. To accomplish these goals, the IRS is redefining itself to better serve each segment of the taxpayer community.

Reorganization design work is progressing in phases. Phase I validated the concept of organizing into four operating divisions: Wage and Investment, Small Business and Self Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. In Phase IIA design teams of employees, working in partnership with Booz-Allen & Hamilton consultants, developed a comprehensive blueprint of the new organization. These Phase IIA teams completed their work in April, 1999.

The implementation planning phase, Phase IIB, began in June and concluded in mid-December. More than 500 employees and consultants worked to convert the blueprint designs into detailed action plans to transition from the old organizational structure to the modernized IRS.

Although transitioning the IRS is an evolving process, many key actions occurred in 1999 to move us closer to our modernization goals. The first Division Commissioner was named in April to lead Tax Exempt and Government Entities (TE/GE). IRS selected the Deputy Commissioner for TE/GE in October. Leadership for Large and Mid-Size Business was established in July. The National Taxpayer Advocate organization is currently building its field structure in compliance with RRA 98.

Executives have also been selected to advance the reorganization of other business units. The Appeals organization and Agency Wide Shared Services, having named their top executives, are positioned to implement their design plans. Internal and external searches for the heads of all other business units have also been completed.

Current plans call for all organizational components to be in place with executive leadership and budget authority by October 2000. Those actions are simply the preliminary steps of implementation. New Phase III teams will refine implementation details early in the new year, working toward the goal of having the modernized structure in place by the end of 2000.

MODERNIZING IRS *(continued)*

Will this massive transformation effort succeed or fail? In the words of Commissioner Rossotti, testifying before Congress, "I am more convinced than ever that we can succeed. We can build an IRS that scrupulously respects taxpayer rights, provides high-quality service and collects taxes efficiently and fairly." Another assessment of the IRS' potential for success was characterized by the General Accounting Office in July 1999 testimony before the House of Representatives as follows: "One great strength of IRS' modernization strategy is its comprehensive approach to change. If implemented in an integrated manner, the five levers of change can fundamentally alter the way IRS interacts with taxpayers."

In spite of this optimism, risks exist, because the greatest one lies in implementation. While we move forward with a clarified direction and much momentum to accomplish the concrete plans for restructuring, we must still give energy and attention to the day-to-day operation of our current organization.

For modernization efforts to succeed, three things are needed. First, continued interest and support from key stakeholders is critical and must be sustained. Second, it is essential that all participants in, and observers of, this process acknowledge the realistic time requirements of full implementation. Energy must be applied to combating the frustration that naturally comes with the impatience of converting vision into reality. And third, continued resource support is necessary to ensure that enough people – and their intellectual capital – remain dedicated to the demanding task of implementation.

The transformation of the IRS into an organization delivering world-class customer service will take the better part of a decade. When the IRS has been successfully modernized, it will be the employees and managers of the IRS, working in partnership with the National Treasury Employees Union, who deserve the credit for accomplishing one of the most significant changes in the agency's history.

THE IRS Y2K CONVERSION PROGRAM

IRS systems and facilities performed normally throughout the rollover weekend into the year 2000 and no significant problems or outages were reported. The 2000 filing season has started smoothly. As a result of the year 2000 effort, standardization of Commercial Off the Shelf (COTS) products, particularly in operating systems, database management systems, and platforms (e.g. Pentium-based Windows NT workstations) has positioned the IRS to proceed with modernization of its information technology base. Management improvements instituted in response to the Year 2000 challenge will serve the IRS for years to come. These improvements include improved project, program, and property management practices.

Application Systems: The IRS repaired 168 application systems consisting of over 96,000 components and over 48 million lines of code. Over 99.99 percent of the application systems lines of code has been renovated and validated as Year 2000 compliant. All but one of the 136 mission critical systems have been made compliant and fully implemented. The Collection Activity Reports (CAR) system has newly developed components currently being tested. CAR is on schedule to be in production at the end of January when it would normally be needed.

Telecommunications: Voice and data networks are operating normally and no significant problems have been reported. The IRS telecommunications infrastructure uses over 68,000 devices consisting of over 2,500 unique products. The entire telecommunications infrastructure has been made Year 2000 compliant with the exception of certain administrative functions for the Voice Mail System, for which a waiver has been requested.

Non-Information Technology: The IRS has full access to all its facilities, and all buildings are safe for occupancy. The IRS occupies a total of 730 buildings, 62 controlled by the IRS and 668 controlled by the General Services Administration (GSA). Sixty-one of 62 IRS controlled buildings have been made Year 2000 compliant, and 655 of 668 GSA controlled buildings have been made compliant.

Historical Costs: From the beginning of Year 2000 conversion activities with the creation of the Century Date Change Project Office in October 1996 through the end of Fiscal Year 1999, the IRS has spent a total of one billion dollars. This includes the Integrated Submission and Remittance Processing (ISRP) Project and the Service Center Mainframe Consolidation (SCMC) Project.

EXHIBIT 5

Project Title	**Total (in millions)**
Century Date Change Project Office	$642.9
Service Center Mainframe Consolidation **(1)**	$320.1
Integrated Submission and Remittance Processing System	$110.5
Total	$1,073.5

Footnote
(1) Reflects static Automated Financial System data (no adjustments of deobligations from FY 1998 and obligations of FY 1999).

Note: Does not include FY 1996 Century Date Change Project Office expenditures of $1.69 million.

CUSTOMER SERVICE

Customer Service initiated significant enhancements to its telephone technology, quality review systems, and, at the same time, implemented many of the technical provisions of the RRA 98. Toll-free taxpayer service was expanded to 7 days per week, 24 hours per day (7/24) and the new 1-800 services were installed to allow taxpayers to discuss balance due notices and proposed assessments with skilled IRS employees. Also, Intelligent Call Routing (ICR) technology was implemented nationwide to direct a taxpayer's call, regardless of the taxpayer's location, to a skilled, first available assistor or to a menu of recorded scripts. However, Customer Service answered only 65.8 million of the 123.5 million incoming calls from taxpayers, delivering a level of service of 53.3% as opposed to the FY 1998 level of 70.0%. This drop of 16.7 percentage points resulted from difficulties in providing experienced taxpayer assistors to cover the expanded hours of service and technical problems connected with the implementation of the ICR, which caused many of our callers to receive busy signals or significant hold times. They subsequently hung up and called again at a later time.

Due to the significant expansion of hours of operation and the resulting problems providing experienced staffing, coupled with the technical problems connected with the implementation of the ICR during FY 1999, Customer Service also dropped 19.7% to 74.1% in its accuracy rating for tax law inquiries. A smaller decrease of 6.2% to 82% for account-related inquiries was directly related to the problems in providing experienced taxpayer assistors. The Centralized Quality Review System (CQRS), which evaluates the quality and accuracy of telephone responses, was expanded to incorporate baseline reviews of toll-free account inquiries as well as tax law inquiries during additional operating hours. In addition, Customer Service instituted customer satisfaction surveys to better understand customer expectations and to assess the effectiveness of our services.

Customer Service continued to simplify notices and written correspondence with taxpayers, and to promote the use of telephones in resolving taxpayer inquiries. Walk-in taxpayer services were expanded to 13 Saturdays in 1999, six of which were designated as Earned Income Tax Credit Awareness Days. A total of 4.7 million taxpayers received tax forms and publications at walk-in taxpayer service sites. Services were standardized nationwide to provide income tax return preparation at all walk-in taxpayer service locations. A total of 892,986 taxpayer returns were prepared at walk-in taxpayer service sites, including those for disabled, low income and elderly taxpayers. In addition, three walk-in taxpayer service sites tested a multilingual interpreter service, which provides access to 140 different languages, for customers who speak little English. During FY 2000 we will provide multilingual interpreter service in 21 additional offices. In 1999, we began implementation of Q-matic, an automated queuing system, installing them in 33 of the 236 walk-in taxpayer service sites. During FY 2000 we will evaluate the system/taxpayer benefits and plan to expand installation to 43 additional sites, pending budget availability.

CUSTOMER SERVICE *(continued)*

The Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs, with more than 70,000 volunteers, assisted approximately 3.5 million taxpayers at more than 18,000 volunteer sites nationwide. IRS district offices conducted more than 1,900 Small Business Workshops for approximately 49,000 small business taxpayers. Through the Community Outreach Program more than 52,000 Outreach sessions, which reached approximately 523,000 taxpayers, were conducted at convenient community locations.

In FY 2000, Toll-Free telephone services will offer Spanish-speaking assistance. Customer Service will provide taxpayer education concerning Powers of Attorney and improve processing timeliness for these taxpayer authorizations. Expanded Intranet resources will provide Customer Service Representatives with online access to tax law references and taxpayer account data in resolving taxpayer inquiries. Electronic Tax Law Assistance, which offers taxpayers access to tax law specialists through the Internet, will be expanded. These additional resources will help us to improve the accuracy (65 percent in FY 1999) and timeliness (4.11 calendar days in FY 1999 versus our goal of 2 days) of our responses to e-mail questions. Customer Service will also continue to develop customer satisfaction surveys and use survey results to improve our services.

NATIONAL TAXPAYER ADVOCATE (NTA)

The IRS RRA 98 mandated significant changes for the Problem Resolution Program. It has a new identity, mission, and vision. The Program was renamed the “Taxpayer Advocate Service (TAS).” This change embodies the role of the new organization which is to help taxpayers solve their problems with the IRS and recommend changes that will prevent future problems.

The name change also signals the first of many other changes that are refocusing outreach efforts to taxpayers and creating global awareness of the TAS and liaison with external and internal stakeholders. TAS is organized around two major functions: “casework” and “systemic analysis and advocacy.” Casework units are responsible for resolving all individual taxpayer problems that meet the redefined TAS criteria. Systemic and advocacy units are responsible for working with IRS operating divisions to identify systemic and procedural problems, analyze root causes of those problems, and implement solutions. During 1999, the Office of the National Taxpayer Advocate achieved the following significant accomplishments:

NATIONAL TAXPAYER ADVOCATE (NTA) *(continued)*

- Resolved just under 200,000 regular TAS cases. In addition, TAS handled almost 93,000 applications for a Taxpayer Assistance Order (TAO) (i.e., requests for relief of hardship).

- Of the 93,000 applications, taxpayers were granted relief or provided appropriate assistance in 73.5% of these cases. For the remaining cases, assistance was not provided because it was determined that relief was not appropriate (20%), the law prevented relief (2%), or requests did not meet hardship criteria (3%). Additionally, 1% of these cases were reapplications or reopened.

- Identified the 20 most serious problems facing taxpayers as reported by tax practitioners, tax associations and groups, IRS functional areas, and TAS staff. The consensus is that the number one problem that tax payers faced in 1999 was complexity of the tax law. The TAS also identified and reported on accomplish ments and long-range plans to address the top 20 problems.

- Coordinated the formation of and provided direction to three additional Citizen Advocacy Panels (CAP). These panels enhance IRS customer service through citizen participation in identifying problems and making recommendations for improvement of local IRS systems and procedures.

- Established a CAP site on the Internet. Among other things, the site has the mission statement for the four CAPs, the IRS CAP charter, the names of the panel members, the telephone number and address for each CAP and timely events. The site links to several other sites including the IRS Digital Daily, National Taxpayer Advocate, White House, Library of Congress and General Service Administration.

- Coordinated Problem Solving Days (PSD), the special trouble-shooting program, which provides taxpayers with the opportunity to meet face-to-face with IRS employees who can assist them in resolving their tax problems. 57,450 cases have been resolved since PSD began two years ago. A national customer survey taken between April and June 1999 showed 93% of participants gave the program's overall service a grade of six or seven — the highest scores possible. Lessons learned and best practices from the PSDs have been incorporated in day to day operations.

SUBMISSION PROCESSING

The IRS receives and processes electronic and paper tax returns and payments as well as collecting almost two trillion dollars annually. In 1999, Submission Processing delivered another successful filing season processing 209.9 million primary returns. Ninety-four million refunds were issued, an increase of 6.7 million over FY 1998. The Service continued its efforts to make it easier for taxpayers to file their tax returns: developing tax forms that are easier to understand and prepare, providing access to alternative means of filing such as home computers or telephones, and providing authoritative guidance through the IRS' award winning Internet site.

The mission of Electronic Tax Administration (ETA) is to revolutionize how taxpayers transact and communicate with the IRS. A record setting 29 million individual taxpayers, or 19% more than in 1998, filed using one of the three convenient e-file options: 21.2 million taxpayers filed their tax returns electronically through an IRS authorized Electronic Return Originator (ERO); a 19.9% increase over the same period last year. On-line filing skyrocketed as over 2.4 million taxpayers filed their tax returns on-line via their home computers through a third party transmitter; an increase of 161% over last year. Five million and seven hundred thousand taxpayers filed their returns over the telephone using the TeleFile system. Also, over 106,000 taxpayers filed both their federal and state returns in a single telephone call during the pilot of the first Federal/State TeleFile option. In spite of the significant increase in all ETA programs, current IRS projections of electronic filing patterns indicate that the IRS must do more to meet the goals established by Congress in RRA 98.

Two pilot programs provided a paperless filing experience for over one million taxpayers. These pilots involved the use of Personal Identification Numbers (PINs) as the taxpayer's signature, eliminating the need to file the paper jurat. More than 659,000 taxpayers participated in the on-line Signature Pilot in which the IRS distributed e-file Customer Numbers to taxpayers who prepared their own returns using tax preparation software to file from their home computers. Approximately 500,000 taxpayers participated in the Practitioner Signature Pilot in which taxpayers selected a PIN when filing through 2,500 participating practitioners.

Though this was the baseline year for the new methodology used in measuring Refund Timeliness for paper processing, the results for FY 1998 were recalculated using this methodology to provide a basis for comparison. The decline in FY 1999 performance (83.2% as compared with 85.5% in FY 1998) was primarily due to the transshipment of tax returns from one understaffed processing center (created by the strong local economy) to those with more optimal employment levels. This increased the time needed to process the affected returns and issue the refunds. Excluding the performance of that one center, the FY 1999 performance level was 85%.

In the General Accounting Office (GAO) report "IRS' 1999 Tax Filing Season, "GAO recommended that Submission Processing analyze the results of the refund timeliness tests to determine, among other things, why about 15% of the refunds took longer than 40 days to issue and what the test results showed for returns that were filed error-free. The Commissioner, in his response letter, said that the IRS is "in the process of obtaining an extract from which we can perform an initial analysis. We will be able to tell which returns had a math error, but not those on which we corresponded

SUBMISSION PROCESSING *(continued)*

or on which there was an unpostable condition. Therefore, we cannot, based on the extracted data alone, identify whether a return was truly error-free. Depending on our findings in the initial analysis, we may make a decision to pull the returns and conduct a more extensive analysis. If we do further analysis, we will be able to determine the results for returns filed error-free. The results of the initial analysis will be completed on or before February 1, 2000." We have included actions to address this recommendation under the FY 2001 and FY 2000 Service to All Taxpayers goal narratives in the FY 2001 Congressional Justification of the President's Budget.

The IRS Internet site "The Digital Daily" continues to be extremely popular. During the January through April 1999 filing season, the site received more than 767 million "hits" (information accesses) compared to over 300 million for the same period in 1998. There were 57 million downloaded files in the January to April 1999 period, an increase of 100% over the 28 million downloaded during the same period of 1998. In FY 1999, the following applications were provided through the enhanced IRS Internet site to improve customer service.

On-line Installment Agreement – Delinquent taxpayers meeting IRS criteria are allowed to use the web to initiate a payment agreement on overdue taxes. This application was designed to complete the agreement with secure taxpayer data on the taxpayer's personal computer, not on the IRS Internet site. The taxpayer then has the option of printing, signing and faxing or mailing the completed agreement to the IRS at the address provided. Taxpayers still have the option of coming to an office to make agreements but this online option will significantly reduce the walk-in taxpayer service traffic and telephone time devoted to installment agreements.

Expanded On-Line Customer Service – Expanded use of online customer service technologies, such as the "Mailman" application that allows taxpayers to submit questions to Customer Service Representatives on the Internet site and receive responses via e-mail, provides greater customer access to IRS help while on "The Digital Daily." Questions received via e-mail are similar to those received by telephone in that they can cover a range of topics from tax law, questions about a specific account, or to request for guidance about a specific issue on a tax form. However, the accuracy and timeliness for the responses provided to e-mail questions are determined differently from telephone responses because telephone assistance is reviewed while the taxpayer is on the telephone with the assistor and e-mail questions are handled much like other taxpayer correspondence. Assigning additional resources to this program in FY 2000 will help us improve the accuracy (65 % in FY 1999) and timeliness (4.11 calendar days in FY 1999 versus our goal of two days) of our responses to e-mail questions. Specialized services such as employment tax help were piloted successfully.

Notice Information On The Web – This new application answers the most frequently asked questions about IRS' highest volume notices such as "Math Error – Overpayment of $1 or more" and "Balance Due, No Math Error." It instructs taxpayers on how to determine which notice they have, what they should do next and who to contact if they disagree with the notice.

COMPLIANCE

Criminal Investigation (CI)

During Fiscal Year 1999, the independent review of the Criminal Investigation Division (CID) by a task force headed by Judge William Webster was completed. The Webster report concluded, "CID is an organization of dedicated, talented and hardworking individuals who carry out their law enforcement responsibilities in a professional manner." With this report as a foundation, the CI Design Team began their task of creating a high-level infrastructure for the new Criminal Investigation Division in a modernized IRS. Both the Webster Report and the CI Design Team generated recommendations for significant changes to CI.

To better fit into a new IRS, CI revised its mission statement to read, "CI serves the American public by investigating potential violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law."

CI developed an Interim Compliance Strategy, which enables CI to efficiently direct its resources to accomplish the IRS mission. The Strategy is a critical component of a balanced enforcement program that is designed to promote tax compliance, address emerging areas of fraud, and support national crime initiatives. CI's primary resource commitment is to develop and investigate legal source tax investigations. These tax investigations involve legally earned income in which the primary motive is the violation of tax statutes.

Criminal Investigation played a key role in the development of the National Money Laundering Strategy jointly endorsed by the Department of Treasury and the Department of Justice. Money laundering is a financial crime and is sometimes referred to as "tax evasion in progress." This National Strategy will require the financial expertise of CI special agents in joint, multi-agency investigations.

Examination

During the past year, IRS employees examined 506,510 income tax returns. The Service's response to the increased sophistication of transactions in the financial world and specialization in the business community is reflected in the cooperatively developed Market Segment Specialization Program guidelines. The Market Segment Specialization Program guidelines focus on the practical problems that occur while examining the tax returns of a specific market segment, such as the construction industry or a specialized profession such as real estate agents. In identifying particular issues of interest to the IRS and sharing this information with professional groups and industry specific associates, employers and employees in these groups and industries gain greater insight into IRS concerns. Through September 1999, the Service issued 51 Market Segment guidelines that can be obtained through the Government Printing Office. In addition, 45 of the guidelines are also available on the IRS Home Page, "The Digital Daily", at **www.irs.gov** in the *Tax Info For Business* section.

COMPLIANCE *(continued)*

In partnership with private industry, IRS also developed two initiatives that benefit both employers and employees – the Tip Rate Determination Agreement (TRDA) and the Tip Reporting Alternative Commitment (TRAC). The benefit to employers is that significant unplanned tax liabilities will not be assessed against them. Employees benefit from the increased income reported to their Social Security accounts, the increased payments of Federal Unemployment Tax on their behalf and the increased contributions to their retirement plans. To date, IRS has received approximately 200 TRDAs, representing agreements with 2,607 establishments and 10,035 TRAC agreements covering 30,926 establishments.

In response to the Service's emphasis on customer service, employees from the Examination organization provided substantial support to customer service programs. In FY 1999, Examination employees expended 925,829 hours on customer service duties, which was approximately a 40% increase over the previous year. Although Examination employees assisted on the telephones, prepared tax returns, answered taxpayer questions via e-mail, the increased time was spent on walk-in taxpayer service activities.

Collection

The impact of the Internal Revenue Service RRA 98 has been extensive, establishing new taxpayer rights and protections and changing many aspects of the collecting process. To address the RRA 98 issues, Collection developed training materials, updated procedural manuals, created requests to update our information systems, and conducted teleconferences and focus group interviews to determine how these changes are impacting Collection employees.

With the IRS' increased focus on customer service, Collection provided substantial support to customer service toll-free and walk-in taxpayer service in FY 1999. To address dwindling resources and increasing workload, Collection has continued to develop systems that prioritize the work and allocate resources, direct work to the right employee at the right time, predict a taxpayer's ability to make payment on a tax liability, and remove inventory cases that are deemed unproductive. In addition, the Collection Quality Measurement System posted an overall baseline score of 86% during FY 1999.

Collection increased its outreach efforts to educate taxpayers and practitioners on the Offer in Compromise program. It revised the offer form and instruction booklet to make them more understandable and available on the Internet. It created an additional basis for compromise. These enhancements resulted in a more visible program, thereby increasing its use by taxpayers to satisfy their tax obligations. However, due to a decrease in staffing in Field Collection, fewer employees were available to work the offers received. Performance in the Percentage of Offers in Compromise measure declined 9.1 percentage points in September FY 1999 compared to September FY 1998.

In the last two years, there has been a general decline in case dispositions and enforcement activities (seizures, issuance of liens, levies.) Taxpayer Delinquency Account and Taxpayer Delinquency Investigation Dispositions have declined 22.0% and 34.2%, respectively, as of September FY 1999 compared to the same period last fiscal year. The Percentage of Overage Cases increased 3.3 percentage points in September of FY 1999 as compared to September FY 1998. These

COMPLIANCE *(continued)*

declines are caused by decreased staffing availability (1,000 fewer FTE), increased numbers of Collection employees supporting toll-free and walk-in taxpayer service activities and the provisions of RRA 98 requiring that additional processing time be granted to the taxpayer prior to certain Collection activities. Redesign of the "collecting process" efforts, which are expected to positively impact taxpayers, are in high gear. The areas of emphasis for the redesign include: (1) expanding the streamlined installment agreement, (2) providing direct debit for installment agreements with a reduced user fee, (3) implementing a twelve month installment agreement, (4) expanding case resolution authority for currently not collectible accounts, (5) centralizing the offer in compromise program, and (6) developing a prototype for a "mentor and monitor" program for employers.

Employee Plans and Exempt Organizations (EP/EO)

Employee Plans/Exempt Organizations (EP/EO) was involved in several initiatives to enhance customer service during FY 1999. The implementation of a centralized nationwide, toll-free customer service call site for EP/EO; the centralization of front-end processing of all determination letter applications; the continuation of centralized EO returns processing, including imaging returns, and the centralization of the tax-exempt bond returns processing advanced the efficient and fair administration of these EP/EO sectors. Other initiatives to enhance customer service were the implementation of uniform procedures for transferring taxpayer inquiries and the continued emphasis on educational outreach efforts to the EP and EO communities.

EP/EO established an educational outreach program, Partnership for Compliance, which creates a partnership between IRS and the public to increase understanding and compliance with tax laws applicable to Internal Revenue Code (IRC) section 403(b) tax-sheltered annuities. In FY 1999, speeches were made to public school sponsors of IRC 403(b) annuities and other organizations.

Guidelines for requesting IRC 403(b) educational outreach services and Internal Revenue Manual (IRM) examination guidelines for IRC 403(b) annuities were posted to the Employee Plans web site. An IRC 403(b) Training Program was implemented to support the development of specialized skills for EP agents involved in examination, voluntary correction and educational activities. The training program provides an opportunity for interaction between EP agents and IRC 403(b) practitioners.

Rapid changes in the health care industry continue to trigger emerging issues that are of concern to both the Exempt Organizations and Examination functions. To confront these challenging issues, such as joint ventures between for-profit (taxable) entities and non-profit (tax-exempt) health care organizations, EP/EO and Examination Divisions in district offices continued to coordinate efforts on joint examinations of health care companies. Greater emphasis continued to be placed on new approaches to increasing compliance in the Market Segment Compliance Program (MSCP) areas.

COMPLIANCE *(continued)*

During FY 1999, EP/EO continued guidance in enhancing customer satisfaction. Significant guidance included: IRM procedures providing guidance to EO field agents in drafting and negotiating closing agreements, and in coordinating with District Counsel and Headquarters; annual Continuing Professional Education (CPE) text which is also available on the Internet; final regulations under IRC section 6104 implementing the disclosure rules for tax-exempt organizations enacted in the Taxpayers Bill of Rights (TBOR) of 1988; Announcement 99-62 advising tax-exempt organizations of the June 8, 1999, effective date for the new disclosure rules; proposed regulations on Applicability of the Disclosure Rules to Private Foundations; proposed regulations on Travel Tours operated by tax-exempt organizations; revised IRM guidelines for tax-exempt bond municipal financing arrangements; Revenue Procedure 99-31 establishing correction methodology for EP Compliance Programs; and Revenue Procedure 99-13 establishing a Tax Sheltered Annuity Voluntary Correction Program in the field offices allowing IRC 403(b) plans the option of self audit and voluntary self correction.

International

International administers U.S. international tax laws, encourages the highest degree of voluntary compliance involving international tax matters and is responsible for all of IRS' various international tax activities. In FY 1999, International provided customer service assistance to more than 386,000 taxpayers worldwide, approximately 3,000 more taxpayers than in FY 1998. The number of tax returns electronically filed from overseas U.S. taxpayers grew as well. For FY 1999, about 103,000 returns were filed electronically as compared to nearly 91,000 for FY 1998. International also oversees tax treaties and tax information exchange agreements on behalf of the U.S. government through the competent authority process.

Tax administration advisory assistance to other countries is facilitated through project teams, training and the international visitors program. Specifically, during FY 1999, International hosted 591 foreign visitors to IRS, and continued providing in-country assistance to the Republic of Georgia, Greece, Turkey, Russia and Puerto Rico. Also, an assistance project was initiated with Trinidad and Tobago.

Office of Chief Counsel

As part of the overall IRS modernization effort, the Office of Chief Counsel has redesigned its organization in order to improve services to both its internal and external customers. The new Counsel organization has been designed to make it as easy as possible for all parts of Chief Counsel's office to work in active partnership with colleagues within the IRS, Treasury and the Justice Department to help accomplish the IRS mission. The new organization will focus on providing the highest quality legal services to the IRS and ensuring that the legal advice provided reflects an impartial professional judgment as to the correct interpretation of the law. Several key decisions helped determine the critical components of the new Counsel structure:

COMPLIANCE *(continued)*

- To maintain consistency, uniformity and impartiality in tax law interpretations, all Counsel personnel will continue to be part of a unified, national Chief Counsel organization.

- To develop an active working partnership with the new IRS Operating Divisions, Counsel has established four new Division Counsel (DC) positions that will be co-located with the operating division Commissioners. Each of these four DC's will have a staff of attorneys at the headquarters location that will be dedicated to serving the needs of the particular operating division.

- Most of Counsel's field attorneys will continue to be located in their current posts of duty, but will be assigned to a Division Counsel and report directly to them. This alignment will provide more specialized legal services to the individual Operating Divisions.

- Counsel's National Office technical experts will remain in Washington, D.C. and will continue to be organized primarily on the basis of the tax law technical subject areas required by the Internal Revenue Code. The National Office will maintain its role of providing authoritative technical interpretations of the tax law that are consistent for all taxpayers and all Operating Divisions.

- The new National Office structure replaces the Associate Chief Counsel (Domestic) office with four new Associate offices having essentially the same subject matter responsibility as the four current Domestic Technical divisions. In addition, this consolidates the current Domestic Field Service Division with the four Technical Divisions, resulting in "full service" offices for the respective technical subject matter areas. Also, a single Associate office for Procedure and Administration will be responsible for the various procedure and administration areas of tax administration, including litigation practice and procedure.

- The National Office international functions will continue to operate as a technical office providing legal advice on international tax issues. Also, the criminal tax and general legal services functions will each be centralized, consolidating the field activities with those of the National Office under one executive.

MANAGEMENT CHALLENGES

In order to ensure that the IRS is not hindered in carrying out its mission, routine audits are regularly performed throughout the year by independent entities such as the General Accounting Office (GAO); Treasury Inspector General for Tax Administration (TIGTA); and, the Office of Inspector General (OIG). These audits may also be supplemented by specialized program reviews, which could be initiated by taxpayer inquiries, Congressional request, or Executive branch directive.

Of the audit findings and recommendations which are made to the IRS annually, the most significant are characterized as "high-risk" because of their greater vulnerabilities to waste, fraud, abuse, and mismanagement. The Service's latest set of findings are reflected in the following 13 items:

1. Tax Filing Fraud
2. Systems Modernization Efforts
3. Receivables
4. Financial Management
5. Improve Security Controls over Information Systems
6. Year 2000 Compliance Progress
7. Protecting Taxpayer Rights and Compliance Activities
8. Filing Season
9. Customer Service
10. Impact of the Global Economy on Tax Administration
11. Organizational Restructuring
12. Revenue Protection
13. Implementation of GPRA

With each finding, the IRS identifies the relevant issue, goal, and actions planned or underway to resolve the deficiency. A performance measure is also established to determine when an issue has been resolved.

The IRS also reports on internal control and financial management system deficiencies (or the lack thereof) through the requirements of the Federal Managers' Financial Integrity Act (FMFIA) and the Federal Financial Management Improvement Act (FFMIA). These and other items are monitored by the IRS' Financial and Management Controls Executive Steering Committee and its predecessor … the Senior Council for Management Controls (SCMC).

EARNED INCOME TAX CREDIT (EITC)

Although not reported as a "high-risk" area, the IRS has addressed a broad range of issues relating to the Earned Income Tax Credit (EITC). EITC is a special credit for persons with or without qualifying children who meet certain requirements and file a tax return. The maximum credit is $2,312 for persons with one qualifying child and $3,816 for persons with two or more qualifying children. The maximum credit is $347 for persons without qualifying children.

FY 1999 initiatives, with the EITC Program Office oversight, increased outreach activities, improved promotional materials to better explain eligibility requirements and increased toll-free assistance availability to those inquiring about EITC. The IRS made it easier for the taxpayer to substantiate EITC entitlement by providing quality customer service with dedicated EITC toll-free assistance. Callers may direct themselves to taped information explaining the credit or to a representative who specifically handles EITC issues. The EITC publication was enhanced to clarify EITC qualifiers and eligibility requirements and special EITC due diligence forms were created to assist paid preparers in filing accurate returns. Community based tax preparation assistance sites are located and staffed in areas with high EITC eligibility. Face to face educational and outreach visitations with practitioners that prepare high volumes of EITC returns are conducted along with due diligence reviews of return preparers. Penalties are applied for non-compliance. IRS information notices are sent to EITC taxpayers with questionable returns to ensure only valid refunds are issued.

The IRS is closely reviewing EITC returns and claims to ensure that the proper refund is issued to taxpayers that are truly entitled to the credit. This is accomplished through enhanced computer identification and selection of questionable EITC claims, and expanded examination and criminal investigation activities. Compliance Research uses a data-driven approach to identify areas of potential non-compliance. The IRS uses Criminal Investigation "Questionable Refund Detection Teams" to screen for and identify questionable EITC claims, EITC based refund schemes, and questionable EITC return preparers. The IRS works with the Social Security Administration to provide enhancements to its social security number database in order for the IRS to gain EITC compliance and to reach EITC eligibles that are not aware of the Earned Income Tax Credit.

The IRS will continue to revise the tax forms and instructions and partner with the practitioner community, return preparers, and Commercial Off-The-Shelf tax preparation software developers, to maintain up front integrity of the EITC program.

MOST UNPAID ASSESSMENTS ARE NOT RECEIVABLES AND ARE LARGELY UNCOLLECTABLE

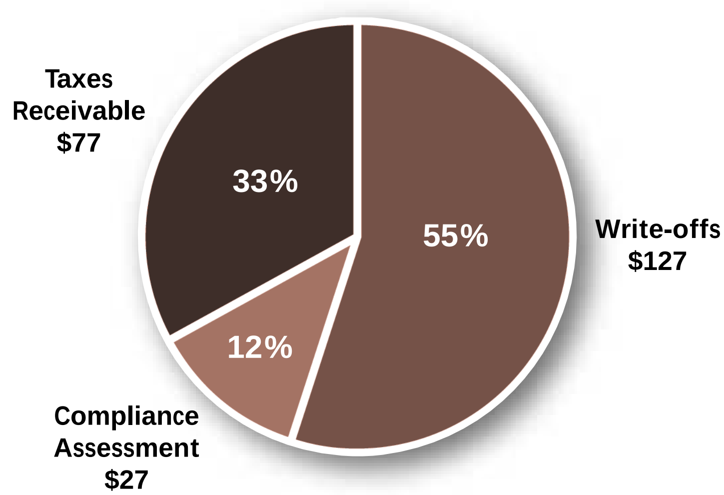
As reflected in the supplemental information to IRS' fiscal year 1999 Financial Statements, the unpaid assessment balance was about $231 billion as of September 30, 1999. This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment, as well as from the Service's enforcement programs such as Examination, Under Reporter, Substitute for Return, and Combined Annual Wage Reporting. A significant portion of this balance is not considered a receivable. Also, a substantial portion of the amounts considered receivables is largely uncollectible.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments with little or no future collection potential are called write-offs.

Exhibit 6 depicts the components of the unpaid assessments balance as of September 30, 1999.

EXHIBIT 6

Components of the IRS' $231 Billion of Unpaid Assessments (Dollars in Billions)



Of the $231 billion balance of unpaid assessments, the $127 billion is write-offs. Write-offs principally consist of amounts owed by deceased, bankrupt or defunct taxpayers, including many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). As noted above, write-offs have little or no future collection potential but statutory provisions require that these assessments be maintained until the statute for collection expires. In addition, $27 billion of unpaid assessments is the total amount that has not been agreed to by either the taxpayer or a court.

MOST UNPAID ASSESSMENTS ARE NOT RECEIVABLES AND ARE LARGELY UNCOLLECTABLE *(continued)*

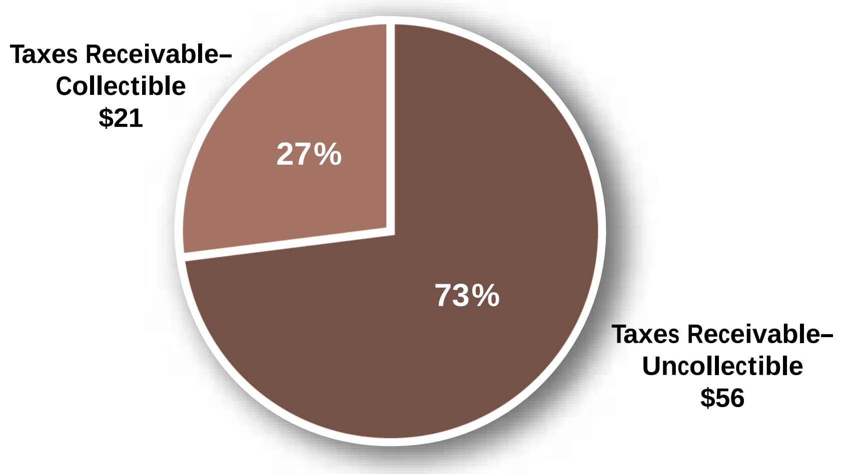
These assessments result primarily from the Service's various enforcement programs to promote voluntary compliance such as Examination, Under Reporter, Substitute for Return, and Combined Annual Wage Reporting. Due to the lack of agreement, these compliance assessments are less likely to have potential for future collection than the unpaid assessments that are considered federal taxes receivable.

The remaining $77 billion of unpaid assessments represent federal taxes receivable. About $56 billion (73 percent) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, such as individual taxpayers who are unemployed, or have other financial problems. However, IRS may continue collection action for 10 years after the assessment or longer under certain conditions. Thus these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves. About $21 billion, roughly 27 percent, of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, confirmed payment plans through bankruptcy, as well as relatively newer amounts due from individuals and businesses who have a history of compliance.

Exhibit 7 depicts the taxes receivable balance that is considered collectible and uncollectible as of September 30, 1999.

EXHIBIT 7

Components of IRS' $77 Billion of Taxes Receivable (Dollars in Billions)

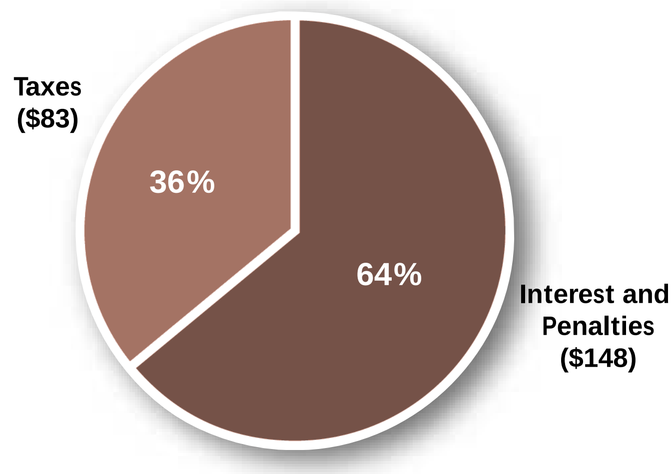


MOST UNPAID ASSESSMENTS ARE NOT RECEIVABLES AND ARE LARGELY UNCOLLECTABLE *(continued)*

It is also important to note that the unpaid assessment balance consists of the unpaid assessed tax, penalty and interest, as well as accrued penalty and interest computed through September 30, 1999. About $148 billion, roughly, of the unpaid assessment balance as of September 30, 1999 is from interest and penalties, as depicted in Exhibit 8, which are also largely uncollectible.

EXHIBIT 8

Unpaid Taxes and Interest and Penalty Components of $231 Billion in Unpaid Assessments (Dollars in Billions)



Interest and penalties are such a high percentage of the balance because IRS must continue to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, as well as on exam assessments where taxpayers have not agreed to the amount assessed. The overall growth in unpaid assessments during fiscal year 1999 was mostly attributable to the accrual of interest and penalties.

LIMITATIONS OF THE FINANCIAL STATEMENTS

The financial statements have been prepared to report the financial position and results of operations of the IRS, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the IRS in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

BALANCE SHEET (IN MILLIONS)
AS OF SEPTEMBER 30, 1999

ASSETS

Intragovernmental:	
Fund balance with Treasury and cash (Note 2)	$ 2,156
Due from Treasury (Note 12)	1,407
Accounts Receivable, Net (Note 3)	21
Advances to government agencies	131
Other Assets (Note 4)	8
Total Intragovernmental	3,723
With the Public:	
Federal Taxes receivable, net of	
allowance for doubtful accounts of $56,000 (Notes 5, 12)	21,000
Accounts Receivable, Net (Note 3)	8
Advances to the public	12
Other assets (Note 4)	66
Total With the Public	21,086
Property and equipment, Net (Note 6)	1,281
Total Assets	**$26,090**

LIABILITIES

Intragovernmental:	
Due to Treasury (Notes 5, 12)	$21,000
Accrued expenses (Note 7)	89
Other liabilities (Note 8)	71
Total Intragovernmental	21,160
Federal tax refunds payable (Note 12)	1,407
Accounts payable (Note 7)	53
Accrued expenses (Note 7)	422
Other liabilities (Note 8)	788
Capital lease liability (Note 9)	65
Contingencies (Note 10)	19
Total Liabilities	**23,914**

NET POSITION

Net Position (Note 11)	2,176
Total Liabilities and Net Position	**$26,090**

The accompanying notes are an integral part of these statements.

STATEMENT OF NET COST (In Millions)
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1999

Programs	Cost	Exchange Revenue	Net Cost of Operations
Compliance	$4,925	$(200)	$4,725
Customer Service	2,049	(20)	2,029
Submission Processing	1,489	(12)	1,477
Subtotal	$8,463	$(232)	**$8,231**
Net Cost of Operations			**$8,231**

The accompanying notes are an integral part of these statements.

STATEMENT OF CHANGES IN NET POSITION (In Millions)

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1999

NET COST OF OPERATION	**$8,231**
Financing Sources (other than exchange revenue)	
Appropriations used	8,226
Imputed financing	415
Total Financing Sources	**8,641**
Net Results of Operations	**410**
Transfers to Appropriated Capital and General Fund	**(129)**
Prior Period Adjustments (Note 16)	**774**
Net Change in Cumulative Results of Operations (Note 11)	**1,055**
Increase in Unexpended Appropriations (Note 11)	**190**
Change in Net Position	**1,245**
Net Position – Beginning of Period	**931**
Net Position – End of Period	**$2,176**

The accompanying notes are an integral part of these statements.

STATEMENT OF BUDGETARY RESOURCES (In Millions)

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1999

BUDGETARY RESOURCES

Budget authority	$8,513
Unobligated balances – beginning of period	434
Spending authority from offsetting collections	128
Adjustments	245
Total Budgetary Resources	**$9,320**

Status of Budgetary Resources	
Obligations incurred	$8,639
Unobligated balances – available (Note 11)	519
Unobligated balances – unavailable	162
Total Status of Budgetary Resources	**$9,320**

Outlays	
Obligations incurred	$8,639
Less: Spending authority from offsetting collections and adjustments	(431)
Obligated balance, net – beginning of period	1,542
Less: Obligated balance, net – end of period	(1,527)
Total Outlays	**$8,223**

The accompanying notes are an integral part of these statements.

STATEMENT OF FINANCING (In Millions)

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1999

Obligations and Nonbudgetary Resources	
Obligations incurred	$8,639
Less: Spending authority from offsetting collections and adjustments	(431)
Financing source — imputed financing	415
Exchange revenue not in the budget	(128)
Total Obligations, as Adjusted, and Nonbudgetary Resources	**8,495**
Resources That Do Not Fund the Net Cost of Operations	
Change in amount of goods, services, and benefits ordered but not yet received or provided	17
Costs capitalized on the Balance Sheet	(614)
Increase in prepayments	(6)
Financing sources that fund costs of prior periods	(12)
Total Resources That Do Not Fund the Net Cost of Operations	**(615)**
Costs That Do Not Require Resources	
Depreciation and amortization	332
Total Costs That Do Not Require Resources	**332**
Financing Sources Yet to be Provided	19
Net Cost of Operations	**$8,231**

The accompanying notes are an integral part of these statements.

STATEMENT OF CUSTODIAL ACTIVITY (In Billions)

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1999

REVENUE ACTIVITY

Collections of Federal Tax Revenue (Note 14)	
Individual income, FICA/SECA, and other	$1,588
Corporate income	216
Excise	59
Estate and gift	28
Railroad retirement	5
Federal unemployment	7
Total Collections of Federal Tax Revenue	**1,903**
Decrease in federal taxes receivable, net	(5)
Total Federal Tax Revenue	**1,898**
Distribution of federal revenue to Treasury	(1,903)
Decrease in amount due to Treasury	5
NET FEDERAL REVENUE ACTIVITY	**$0**

FEDERAL TAX REFUND ACTIVITY (Note 15)

Total Refunds of Federal Taxes	**$185**
Appropriations Used for Refund of Federal Taxes	(185)
NET FEDERAL TAX REFUND ACTIVITY	**$0**

The accompanying notes are an integral part of these statements.

NOTE 1
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Internal Revenue Service (the Service) is a bureau of the U.S. Department of the Treasury (Treasury). The Service originated in 1862, when the Congress established the Office of the Commissioner of the Internal Revenue. In 1952, the Bureau was reorganized by Congress and in 1953 became the Internal Revenue Service (IRS).

Congress enacted legislation in 1998 to reorganize the structure and management of the Service. The legislation directs the Commissioner to modify the geographic organizational structure of national, regional and district divisions to establish units serving groups of taxpayers with similar needs, and to ensure an independent appeals process. Over time, the legislation will have a pervasive and significant impact throughout the organization, and, in addition to its effect within the Service, will require conforming changes to numerous statutes, regulations and delegations.

The mission of the Service is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

B. Basis of Presentation

The accompanying financial statements report the Service's financial position as of September 30, 1999, and its net cost of operations, changes in net position, budgetary resources, financing and custodial activity for the year then ended. These statements include the accounts of all funds under the Service's control, which have been established to account for the resources of the Service, as well as funds for the purpose of recording tax revenues and refunds. They were prepared from the Service's accounting and financial management systems in accordance with Office of Management and Budget (OMB) Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended, and the Service's accounting policies which are summarized in this note.

C. Basis of Accounting

The accompanying financial statements are presented on a basis in accordance with generally accepted accounting principles (GAAP) for federal government entities.

Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position
These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when costs are incurred or goods or services are received, without regard to receipt or payment of cash. The statement of net cost presents the full cost associated with the Service's major programs.

Statement of Budgetary Resources
The statement of budgetary resources is presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. This financial statement is in addition to the reports prepared by the Service throughout the year pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources.

Statement of Financing
The statement of financing is presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

Statement of Custodial Activity

The statement of custodial activity is presented primarily on the modified cash basis of accounting. Specifically, total federal revenue is recognized when received and is reported net of the change in federal taxes receivable. The related distribution of all such collections to the U.S. Treasury, however, is reported on the cash basis. Refunds of taxes and interest, as well as Earned Income Tax Credit (EITC) and child tax credit payments, are also reported on the modified cash basis. Specifically, refunds, EITC payments, and child tax credit payments are recognized when disbursed and are reported net of the change in federal tax refunds payable.

D. Financing Sources and Exchange Revenue

The Service receives the majority of its funding through annual, multi-year, no-year, and trust fund appropriations that are available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The following are the different types of operating appropriations:

Processing, Assistance and Management

This appropriation provides funds for processing tax returns and related documents; assisting taxpayers in filing of their returns and in paying taxes that are due; matching information returns with tax returns; conducting internal audit reviews and internal security investigations; and managing financial resources, rent and utilities.

Tax Law Enforcement

The purpose of this appropriation is to provide funds for the examination of tax returns, and the administrative and judicial settlement of taxpayer appeals of examination findings. It also provides for issuing technical rulings, monitoring employee pension plans, determining qualifications of organizations seeking tax-exempt status, examining tax returns of exempt organizations, enforcing statutes relating to detection and investigation of criminal violations of the internal revenue laws, collecting unpaid accounts, compiling statistics of income and compliance research, and securing unfilled tax returns and payments.

Information Systems

This appropriation funds data processing and information and telecommunication support for the Internal Revenue Service activities, including developmental information systems and operations information systems. The operational systems are located in a variety of sites including the Martinsburg Computing Center, the Detroit Computing Center, the Tennessee Computing Center, and in regional and district offices and service centers.

Other

These budgetary accounts consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. Information Technology Investments appropriation is the largest of these funds and may not be obligated until a plan for expenditure is approved by Congress.

The Service also enters into reimbursable agreements with Treasury, bureaus of Treasury, and other federal entities to accomplish program objectives. Under these arrangements, the Service provides, or receives, goods or services at an agreed-upon price that usually covers all applicable costs. Revenue from reimbursable agreements is recognized when the services are provided and costs are incurred. The Service also receives revenue from user fees charged to the public for miscellaneous services including new and restructured installment agreements, enrolled agent fees and photocopy fees.

In addition, the Service incurs certain costs that are paid in total or in part by other federal entities, such as pension costs administered by the Office of Personnel Management and legal judgments paid by the Treasury Judgment Fund. These constitute subsidized costs and are recognized by the Service on its statements of changes in net position and financing as an imputed financing source equal to the cost paid by the other federal entity.

E. Fund Balance with Treasury and Cash

Fund balance with Treasury is the aggregate amount of funds in the Service's accounts including appropriated funds from which the Service is authorized to make expenditures and pay liabilities as well as funds in deposit, suspense, and clearing accounts. Generally, cash receipts and disbursements are processed by the Treasury. Imprest funds are maintained by regional offices in commercial bank accounts.

F. Accounts Receivable, Net

Accounts receivable consists of amounts due from federal agencies, state and local governments, and the public. The balance of accounts receivable for reimbursable services includes both billed and unbilled receivables. Unbilled accounts receivable are recorded, and reimbursable revenues are recognized, as the services are performed and costs are incurred. The unbilled receivables are later transferred to billed accounts receivable when bills are rendered to the buying agencies. The allowance for doubtful accounts is based on an annual review of groups of accounts by region, age and account type and includes accounts receivable balances older than one year.

G. Advances

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Amounts in the fund are available for expenses of operating and maintaining common administrative services of Treasury that can be performed more economically as a centralized service. Centralized services funded through the Treasury WCF for the Service consist primarily of telecommunications services and payroll processing. In accordance with established WCF procedures, Treasury Departmental Offices collect funds for these services in advance from Treasury Bureaus. Advances are expensed as services are provided by the WCF. This account also includes amortized advances representing assets with a useful life greater than one year.

The majority of advances to the public are for investigations and employee travel advances, which are expensed upon receipt of required expense reports.

H. Property and Equipment

The balances for certain categories of Property and Equipment as of September 30, 1999 were derived based upon estimates of the net book value of a statistically selected sample of assets, using techniques prescribed by the Uniform Standards of Appraisal Practice. These estimated net book values were then projected to the entire population of assets. Reported balances for equipment held under capital leases, leasehold improvements, other major systems costs and vehicles and investigative equipment of the Treasury Inspector General for Tax Administration (TIGTA) are based upon historical costs less estimated depreciation at September 30, 1999.

Property and equipment includes ADP equipment, telecommunications equipment, office equipment and furniture, investigative equipment and vehicles.

This category comprises ADP and telecommunications equipment acquired in connection with major systems projects, as discussed below. It includes property held under capital leases as well as purchased assets. With the exception of small expendable computer peripherals such as keyboards and cables, all property and equipment is capitalized regardless of the dollar amount of individual assets.

In accordance with Office of Management and Budget guidance, the Service capitalizes costs incurred in connection with major systems projects. The Service has identified five major systems projects: the Mainframe Consolidation Project; the Integrated Remittance and Submission Processing System; the Call Router System, the Case Processing System; and the Electronic Filing System. ADP and telecommunications equipment for major systems including hardware, software, transportation charges and installation costs are capitalized with general property and equipment as discussed above. In addition to these equipment acquisition costs, other costs such as labor and certain indirect costs for the design, acquisition, and implementation of major systems are capitalized separately as other major systems costs, while costs associated with preparation of facilities to house the systems are classified as leasehold improvements. Other major systems costs are capitalized without regard to a dollar threshold. A $50,000 threshold is used for leasehold improvements.

Property and equipment of the Treasury Inspector General for Tax Administration (TIGTA), primarily vehicles and investigative equipment, is capitalized on the Service's financial statements in FY 1999. TIGTA property is capitalized without regard to a dollar threshold. See Note 1.I. below for a more complete discussion of TIGTA.

Major systems are considered placed in service when development is complete; the system is in all important respects ready for use, deployment of the system is underway, and significant systems changes are not anticipated. Until placed in service, major systems are shown as Work in Process.

Depreciation is calculated based on the estimated net book values and projected remaining useful lives of the assets as of September 30, 1999.

I. Treasury Inspector General for Tax Administration (TIGTA)

The Treasury Inspector General for Tax Administration (TIGTA) is a new Treasury office established under the IRS Restructuring and Reform Act of 1998. A separate financial plan was established to identify and separate the funds for TIGTA. Because TIGTA was established as an independent entity during the year and did not receive a separate appropriation at that time, all TIGTA financial information is included within the Service's financial statements for FY 1999. During FY 1999, the Service and TIGTA worked under a Memorandum of Understanding (MOU) to arrange for budgetary resources, personnel support and services to be provided by the Service to TIGTA. Under this agreement, the Service provided TIGTA key services: personnel services including staffing and position management, executive personnel support services, employee relations and other personnel services; computerized systems including accounting, payroll processing, personnel and travel systems; office space, telecommunications, postage and other miscellaneous services.

J. Permanent and Indefinite Funds

The Service uses a special class of funds, designated as "permanent and indefinite," to disburse tax refund principal and related interest. These permanent and indefinite funds are not subject to budgetary ceilings set by the Congress during the annual appropriation process. Because the refunds, from a budgetary standpoint, are permanently funded by the Congress, refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end tax refund liabilities, which are reflected in the funds used for refund of federal taxes on the statement of custodial activity along with tax refund payments for the year.

Although funded through the appropriation process, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity in that they are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the statement of net cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the statement of net cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

K. Tax Assessments and Abatements

Under the Internal Revenue Code Section 6201, the Commissioner of the IRS, as delegated by the Secretary of the Treasury, is authorized and required to make inquiries, determinations, and assessments of all taxes which have been imposed and are accruing under any internal revenue law but which have not been duly paid (including interest, additions to the tax, and assessable penalties). Unpaid assessments result from taxpayers filing returns without sufficient payments, as well as from the Service's enforcement programs, such as examination, underreporter, substitute for return, and combined annual wage reporting.

The Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (e.g., a qualifying corporation claimed a net operating loss that created a credit that can be carried back to reduce a prior year's tax liability, amended tax returns, correction of an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors, and assessments contested after the liability has been satisfied). Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

L. Federal Taxes Receivable

Federal taxes receivable and the corresponding liability, "Due to Treasury," are not accrued until related tax returns are filed, or assessments made, and prepayments netted against liabilities. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest), due from taxpayers, for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the Service. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments in which neither the taxpayer or a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results of the audit or examination. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. These amounts are also not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

M. Capital Lease Liability

Certain computer equipment related to the Main Frame Consolidation Project and other office equipment is leased under Lease-To-Ownership-Plans (LTOP). The terms of these LTOP's provide for 36 monthly payments (for computers) and 48 monthly payments (for other equipment). Under each LTOP, the equipment is owned as of the last monthly payment. These LTOP leases are classified as capital leases. The liability reported represents the present value of future lease payments required by the terms of the capital leases.

NOTE 2.

FUND BALANCE WITH TREASURY AND CASH

(In Millions)

Fund balance with Treasury and cash as of September 30, 1999, consist of the following:

Appropriated and other funds	$2,153
Imprest funds	3
Fund Balance with Treasury and Cash	$2,156

The Information Technology Investments fund represents $505 of the appropriated fund balance which can only be obligated pursuant to an expenditure plan approved by Congress. As of September 30, 1999, Congress had approved $35 million. Other funds primarily consist of user fees, suspense, deposit, and clearing funds.

NOTE 3.

ACCOUNTS RECEIVABLE, NET (In Millions)

Accounts receivable and allowances for uncollectible accounts as of September 30, 1999, consist of the following:

	Intra-Governmental	With the Public
Accounts receivable	$37	$12
Allowance for uncollectible accounts	(16)	(4)
Accounts Receivable, Net	$21	$8

NOTE 4.

OTHER ASSETS (In Millions)

Other assets, as of September 30, 1999, consist of the following:

	Intra-Governmental	With the Public
Other custodial assets	$ –	$62
Federal tax revolving fund	$ –	4
Suspense	8	$ –
Total, Other Assets	**$8**	**$66**

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. As described in Note 12, other custodial assets are classified as "Non-Entity Assets" and are offset by an equal liability in other custodial liabilities.

The Federal tax revolving fund primarily consists of real property held for resale to the public. The Federal tax lien revolving fund is authorized, in cases involving delinquent taxes, to purchase real property which has been foreclosed by mortgage lenders. The property is acquired at public auction with the intention of reselling it at a higher price. When the property is resold, the net proceeds are applied to unpaid tax deficiencies of the original property holder, and the remaining balance, if any, is returned to the taxpayer.

Suspense primarily represents funds disbursed from the Fund Balance with Treasury that will be recognized as expenses when final documentation and review are completed.

NOTE 5

FEDERAL TAXES RECEIVABLE, NET

Federal taxes receivable (gross) was $77 billion as of September 30, 1999, and consisted of tax assessments, penalties, and interest which were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable, net, equaled $21 billion as of September 30, 1999, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $56 billion was established for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

NOTE 6

PROPERTY AND EQUIPMENT (IN MILLIONS)

Property and equipment as of September 30, 1999, consists of the following:

	Useful Life	Net Book Value
Property and Equipment	3 to 10 years	$773
Other Major Systems	7 years	34
Work in Process – Major Systems	–	254
Leasehold Improvements	10 years	197
Construction in Progress	–	15
Total IRS Property and Equipment		1,273
TIGTA Vehicles and Investigative Equipment	5 to 10 years	8
Total Property and Equipment		**$1,281**

NOTE 7

ACCOUNTS PAYABLE AND ACCRUED EXPENSES (IN MILLIONS)

Accounts payable and accrued expenses as of September 30, 1999, consist of the following:

	Intra-Governmental	With the Public
Accounts payable	–	53
Accrued expenses	52	169
Accrued payroll and benefits	37	253
Total accounts payable accrued expenses	89	$475

NOTE 8

OTHER LIABILITIES (In Millions)

Other liabilities as of September 30, 1999, consist of the following:

	Intra-Governmental	With the Public
Workers' compensation	$71	$365
Accrued annual leave	–	361
Other custodial liabilities	–	62
Total other liabilities	$71	788

Workers' compensation is paid to employees injured on the job or incurring work-related illnesses, as required by the Federal Employees Compensation Act. The Act provides income, medical cost protection and death benefits to covered federal civilian employees and their beneficiaries. The program is administered by the U.S. Department of Labor, which initially pays valid claims and subsequently seeks reimbursement from federal agencies. This liability of $436 at September 30, 1999, includes a current portion of $71 and estimated future costs of $365. Estimated future costs have been actuarially determined, and are regarded as a liability to the public because neither the costs nor reimbursement have been recognized by the Department of Labor. Workers' Compensation is included in Liabilities not Covered by Budgetary Resources, as described in Note 13.

Accrued annual leave consists of employees' unpaid leave balances at September 30, 1999, and reflects current wage rates in effect at fiscal year end. Accrued annual leave is included in Liabilities Not Covered by Budgetary Resources, as described in Note 13.

Other custodial liabilities (the offsetting liability to other custodial assets) primarily consist of liabilities to taxpayers for deposits, pending application of the funds to outstanding tax deficiencies.

NOTE 9

CAPITAL LEASE LIABILITY (In Millions)

The capital lease liability as of September 30, 1999, is as follows:

	Total	9/30/00	9/30/01	9/30/02	9/30/03
Main Frame Consolidation	$57	$39	$17	$1	$–
Mail Sorters	15	4	4	4	3
Copiers and Office Equipment	3	1	1	1	–
Total Lease Obligations	$75	$44	$22	$6	$3
Less: Amount Representing Interest	(10)				
Present Value of Lease Payments	$65				

Certain computer equipment related to the Main Frame Consolidation Project and other office equipment is leased under Lease-To-Ownership-Plans (LTOP). The terms of these LTOP's provide for 36 monthly payments (for computers) and 48 monthly payments (for other equipment). Under each LTOP, the equipment is owned as of the last monthly payment. Interest rates range from 9% - 10%. Capital lease liability is included in Liabilities Not Covered by Budgetary Resources, as described in Note 13.

Office equipment and similar items are also leased under operating leases. The substantial majority of these items are leased under one-year contracts. In addition, vehicles are leased under annual lease arrangements from the General Services Administration (GSA) based on the needs of the individual offices. While many of these vehicles are used for several years under annual lease renewals, the vehicles are returned to the GSA when they are no longer needed or are not functioning properly. These leases are also classified as operating leases.

GSA also serves as the lessor for the office space occupied by the Service.

NOTE 10

CONTINGENCIES

As of September 30, 1999, the Service provided an accrual for contingent losses of $19 million for pending and threatened legal matters that, in the opinion of Chief Counsel, are considered probable. In addition, estimated losses of $7 million are considered reasonably possible by Chief Counsel, and for which no accrual has been made. Of these amounts, certain settlements and awards may be payable from the Treasury Judgment Fund in accordance with 31 U.S.C. 1304. Of the $19 million accrued by the Service, approximately $17 million may be payable from the Treasury Judgment Fund for settlements and awards relating to these claims. Of the $7 million in reasonably possible losses, approximately $3 million may be payable from the Treasury Judgment Fund.

The Service does not believe it has contractual commitments for payments on obligations related to canceled appropriations.

NOTE 11

NET POSITION (IN MILLIONS)

Net position as of September 30, 1999, consists of the following:

Unexpended Appropriations:	
Unobligated balances	
Available	$519
Unavailable	162
Undelivered orders	946
Total Unexpended Appropriations	1,627
Cumulative results of operations	549
Total Net Position	$2,176

Unexpended appropriations represent the Service's unobligated appropriation balances and undelivered orders as of September 30, 1999. Available unobligated balances represent no-year and multi-year appropriation funds that can be obligated after September 30, 1999. Unobligated balances available includes $480 million of the Information Technology Investments fund. The Service received appropriations totaling $505 million for Information Technology Investments which can only be obligated pursuant to an expenditure plan approved by Congress. Congress has approved $35 million, of which $26 million has been obligated. Unavailable unobligated balances are expired appropriations no longer available to incur new obligations.

The balances of cumulative results of operations and unexpended appropriations were restated at October 1, 1999 to reflect a reclassification of $40 million from cumulative results of operations to unexpended appropriations. The restatement was done to correct balances in the fiscal year 1998 Net Position footnote showing cumulative results of operations overstated by $40 million and unexpended appropriations understated by the same amount.

NOTE 12

NON-ENTITY ASSETS (IN MILLIONS)

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 1999, consist of the following:

	Intra-Governmental	With the Public
Due from Treasury	$1,407	–
Federal taxes receivable, net of allowance for doubtful accounts of $56,000	–	21,000
Other custodial assets	–	62

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 1999.

Federal taxes receivable are transferred to Treasury upon receipt. An amount equal to federal taxes receivable has been recognized as an offsetting intragovernmental liability – Due to Treasury. Federal taxes receivable is described in more detail in Note 5.

Other custodial assets, also discussed in Note 4, primarily relate to the deposits received from taxpayers, pending application of the funds to unpaid tax assessments.

NOTE 13

LIABILITIES NOT COVERED BY BUDGETARY RESOURCES (IN MILLIONS)

Liabilities not covered by budgetary resources as of September 30, 1999, consist of the following:

	Intra-Governmental	With the Public
Workers' compensation	$71	$365
Accrued annual leave	–	361
Contingencies	–	19
Capital Lease Liability	–	65

Liabilities not covered by budgetary resources are liabilities which are not funded by direct budgetary authority and result from the receipt of goods and services, or the occurrence of eligible events, for which appropriations, revenues, or other financing sources necessary to pay the liabilities have not yet been made available through Congressional appropriation. See Note 8 for further description of workers' compensation and accrued annual leave, Note 9 for capital lease liability, and Note 10 for contingencies.

NOTE 14

COLLECTIONS OF FEDERAL TAX REVENUE

(IN MILLIONS)

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item and tax year, was as follows for the fiscal year ended September 30, 1999:

Collections Received		Tax Year			
	FY 1999	1999	1998	1997	Prior years
Individual income, FICA/SECA, and other	$1,588	$1,021 *	$547	$11	$9
Corporate income	216	142 **	63	1	10
Excise	59	39	20	–	–
Estate and gift	28	–	25	1	2
Railroad retirement	5	3	2	–	–
Federal unemployment	7	5	2	–	–
Total	**$1,903**	**$1,210**	**$659**	**$13**	**$21**
	100%	63%	35%	1%	1%

* Includes other collections of $417 million.
** Includes tax year 2000 corporate income tax receipts of $8 billion.

Individual income, FICA/SECA, and other includes $44 billion in payroll taxes collected from other federal agencies. Of this amount, $9 billion represents the portion paid by the employers.

NOTE 15

FEDERAL TAX REFUND ACTIVITY (In Billions)

Refund activity, broken out similarly to collection activity by tax year, was as follows for the fiscal year ended September 30, 1999:

Refunds Disbursed		Tax Year			
	FY 1999	**1999**	**1998**	**1997**	**Prior years**
Individual income, FICA/SECA, and other	$149	$1	$139	$7	$2
Corporate income	34	1	14	6	13
Excise	1	–	1	–	–
Estate and gift	1	–	–	1	–
Railroad retirement	–	–	–	–	–
Federal unemployment	–	–	–	–	–
Total	**$185**	**$2**	**$154**	**$14**	**$15**
	100%	1%	83%	8%	8%

Individual income, FICA/SECA, and other refunds amount includes EITC and child tax credit refunds.

The EITC was originally authorized by the Tax Reduction Act of 1975 (Public Law 94-12) and made permanent by the Revenue Adjustment Act of 1978 (Public Law 95-600). The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. Qualified taxpayers can receive partial credit in advance in each paycheck. In fiscal year 1999, the Service issued $25.6 billion in EITC refunds, of which $96 million was applied to advance EITC. An additional $4.9 billion of the EITC was applied to reduce taxpayer liability.

NOTE 16 (UNAUDITED)

PRIOR PERIOD ADJUSTMENTS (In Millions)

Prior period adjustments were made to record the following items:

Record net book value of assets expensed in prior periods	$792
Correct cumulative results of operations in the prior year	(13)
Other adjustments	(5)
Total Prior Period Adjustments	$774

OTHER CLAIMS FOR REFUND

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. The total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $7.6 billion and by Appeals is $11.4 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information.

FEDERAL TAXES RECEIVABLE, NET

(In Billions)

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS - acting on behalf of the federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net federal taxes receivable at September 30, 1999, were as follows:

Total unpaid assessments	$231
Less: Compliance assessments	(27)
Write-offs	(127)
Gross Federal Taxes Receivable	77
Less: Allowance for doubtful accounts	(56)
Federal Taxes Receivable, Net	$21

The Service cannot reasonably estimate the amount of allowance for doubtful accounts pertaining to its compliance assessments, and thus cannot determine their net realizable value or the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $15 billion, assessed against officers and directors of businesses who were involved in the non-remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

SCHEDULE OF BUDGETARY RESOURCES BY MAJOR BUDGET ACCOUNTS (IN MILLIONS)

Budgetary Resources	Processing Assistance & Management	Tax Law Enforcement	Information Services	Other	Total
Budgetary authority	$3,213	$3,135	$1,813	$352	$8,513
Unobligated balances – beginning of period	26	30	60	318	434
Spending authority from offsetting collections	39	78	5	6	128
Adjustments	70	44	131	–	245
Total Budgetary Resources	**$3,348**	**$3,287**	**$2,009**	**$676**	**$9,320**
Status of Budgetary Resources					
Obligations incurred	$3,287	$3,242	$1,922	$188	$8,639
Unobligated balances – available	9	–	26	484	519*
Unobligated balances – unavailable	52	45	61	4	162
Total Status of Budgetary Resources	**$3,348**	**$3,287**	**$2,009**	**$676**	**$9,320**
Outlays	$3,287	$3,242	$1,922	$188	$8,639
Obligations incurred					
Less: spending authority from offsetting collections and adjustments	(121)	(153)	(139)	(18)	(431)
Obligated balances, net – beginning of period	533	295	706	8	1,542
Less: obligated balances, net – end of period	(501)	(259)	(707)	(60)	(1,527)
Total Outlays	**$3,198**	**$3,125**	**$1,782**	**$118**	**$8,223**

*The Information Technology Investments fund comprised $480 of the unobligated available balance but cannot be obligated until an expenditure plan is approved by Congress.

INTRA-GOVERNMENTAL ASSETS (IN MILLIONS)

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies	Other Assets
Treasury	$2,156	$1,407	$16	$128	$ -
Other	-	-	5	3	8
Total	$2,156	$1,407	$21	$131	$8

INTRA-GOVERNMENTAL LIABILITIES (IN MILLIONS)

Agency	Due to Treasury	Accounts Payable and Accrued Expenses	Accrued Payroll and Benefits	Other Liabilities
Treasury	$ 21,000	$ -	$ -	$ -
Gov. Printing Office	-	16	-	-
General Services Adm.	-	11	-	-
Department of Labor	-	-	-	71
Office of Pers. Mgmt	-	-	37	-
Other	-	25	-	-
Total	$ 21,000	$52	$ 37	$71

CHILD TAX CREDIT

The child tax credit was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In fiscal year 1999, the Service issued $446 million in child tax credit refunds. An additional $14.7 billion of child tax credits were applied to reduce taxpayer liability.

TAX GAP

The tax gap is the aggregate amount of tax imposed by the tax laws for any given tax year that is not paid voluntarily and timely, excluding interest and penalties. Although there is a tax gap for each type of tax, the Service does not have current information upon which to base a reasonable estimate of their magnitude.

The collection gap is the cumulative amount of assessed taxes, including penalties and interest, which the Service expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the Service's balance sheet. The tax gap and the collection gap are related and overlapping concepts. The collection gap includes all of the uncollectible taxes for a particular tax year of the tax gap, and uncollectible taxes from prior years.

TAX BURDEN AND TAX EXPENDITURES

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The tables below present the latest available information on income tax and on related income, deductions, and credits for individuals by income level and for corporations by size of assets. The information illustrates the tax burden borne by different income and asset brackets. The tables are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

Total tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available for government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

The tax expenditures for deductions is calculated using the tax burden percentage of gross income (gross receipts for corporations) applied to the total deductions. Total credits against tax liability result directly in tax expenditure.

INDIVIDUAL INCOME TAX RETURNS (TAX YEAR 1997 DATA)

(IN THOUSANDS)	Size of Adjusted Gross Income					
	Under $15	**$15 under $30**	**$30 under $50**	**$50 under $100**	**$100 under $200**	**Greater than $200**
Total returns	41,442,959	29,403,472	22,754,599	21,635,161	5,377,899	1,807,901
Gross income	$251,879,550	$649,133,310	$895,174,520	$1,490,039,536	$717,301,508	$1,013,376,242
Adjusted gross income	$247,905,412	$642,929,548	$887,886,137	$1,478,927,407	$707,810,825	$1,004,490,653
Tax	$9,066,265	$47,405,241	$90,642,683	$191,641,015	$126,712,802	$274,014,021
Tax burden % of gross income	3.60 %	7.30 %	10.13 %	12.86 %	17.67 %	27.04 %
Average Tax per Return	$219	$1,612	$3,983	$8,858	$23,562	$151,565
Deductions on Taxable Income						
Standard deduction	$175,366,437	$137,233,966	$82,597,364	$42,081,511	$3,563,819	$852,828
Itemized deduction	15,261,739	46,472,056	100,270,066	227,238,858	115,932,769	115,634,682
Medical & dental expense	5,219,993	8,629,481	6,584,476	6,224,793	1,994,117	630,761
Interest paid	5,324,644	18,369,234	45,502,896	99,970,316	46,536,096	34,896,011
Charitable contributions	1,170,536	5,466,441	12,335,025	29,945,760	16,880,392	33,393,805
Other itemized deductions	3,546,566	14,006,900	35,847,669	91,097,989	50,522,164	46,714,105
Total Deductions	$190,628,176	$183,706,022	$182,867,430	$269,320,369	$119,496,588	$116,487,510
Total Expenditures –Deductions	$6,862,614	$13,410,540	$18,524,471	$34,634,599	$21,115,048	$31,498,223
Credits Against Tax Liability						
Child care credit	$43,688	$579,658	$651,690	$927,036	$216,620	$45,313
Credit for elderly and disabled	32,481	8,802	0	0	0	0
Foreign tax credit	11,022	38,935	98,198	261,377	639,085	3,024,843
EITC, offset tax liability	386,516	3,381,476	0	0	0	0
Other Credits	2,335	40,258	117,376	302,276	242,107	1,127,762
Total Credits	$476,042	$4,049,129	$867,264	$1,490,689	$1,097,812	$4,197,918
Total Expenditures – Individual	$7,338,656	$17,459,669	$19,391,735	$36,125,288	$22,212,860	$35,696,141

(All figures are estimates based on samples provided by the Statistics of Income Office)

CORPORATION INCOME TAX RETURNS (TAX YEAR 1996 DATA)

(IN THOUSANDS)	Size of Total Assets					
	Under $1,000	$1,000 under $10,000	$10,000 under $50,000	$50,000 under $100,000	$100,000 under $250,000	Greater than $250,000
Total returns	4,193,284	370,870	42,931	8,475	7,597	8,212
Total receipts	$2,103,706,356	$2,204,250,957	$1,357,281,371	$505,390,049	$741,012,445	$8,614,076,827
Taxable income	$23,987,260	$26,223,912	$25,840,044	$16,289,230	$28,886,085	$518,613,373
Total tax	$5,608,382	$8,095,501	$8,419,769	$5,242,027	$9,018,812	$134,236,455
Tax burden – % of gross total receipts	0.27%	0.37%	0.62%	1.04%	1.22%	1.56%
Average Tax per Return	$1,337	$21,828	$196,123	$618,528	$1,187,154	$16,346,378
Deductions on Taxable Income						
Net operating loss	$10,169,327	$5,567,341	$4,418,220	$2,549,565	$4,173,461	$28,216,598
Dividends received	404,682	537,323	638,157	397,935	851,843	16,896,991
Public utility dividends paid	5	–	–	–	2	70,569
Total Deductions	$2,064,464,946	$2,163,334,835	$1,326,173,989	$486,653,358	$703,438,348	$7,984,023,542
Total Expenditures –						
Deductions	$5,503,766	$7,945,229	$8,226,797	$5,047,685	$8,561,500	$124,418,089
Credits against Tax Liability						
Foreign tax credit	$136,625	$24,948	$135,510	$184,920	$598,113	$39,163,635
U.S. possessions tax credit	5,568	33,774	157,970	201,573	308,939	2,351,476
Non conventional source fuel credit	14,532	3,050	8,603	4,317	9,681	847,192
General business credit	188,888	79,870	107,354	70,153	132,786	3,648,978
Other credits	52,564	143,144	149,843	80,464	137,726	4,109,458
Total Credits	$398,177	$284,786	$559,280	$541,427	$1,188,245	$50,120,739
Total Expenditures–Corporation	$5,901,943	$8,230,015	$8,786,077	$5,589,112	$9,749,745	$174,538,828

(All figures are estimates based on samples provided by the Statistics of Income Office)

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of the United States

United States General Accounting Office
Washington, DC 20548

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To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audit of the financial statements of the Internal Revenue Service (IRS) for fiscal year 1999. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS' administration of its responsibilities for implementing federal tax legislation. These responsibilities include collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed.

Although this report focuses primarily on financial management, tax revenue collection and refund activities, and unpaid tax assessments, it also alerts readers to other significant issues facing IRS, including filing fraud and information systems security weaknesses. IRS continues to face significant financial and other management challenges and risks. We reported on these continuing significant challenges for IRS in the past in our high-risk series[1] and other reports.

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. The size and complexity of IRS' operations present additional challenges to its management. IRS is a large, complex, decentralized organization with about 100,000 people in 4 regional offices, 33 district offices, 10 service centers, 3 computing centers, and numerous other field offices which it operates throughout the United States. Despite the monumental management challenges it faces, in fiscal year 1999 IRS succeeded in collecting about $1.9 trillion in taxes, processing hundreds of millions of tax returns, and paying about $185 billion in refunds to taxpayers.

During fiscal year 1999, we noted that IRS had made a number of improvements to address some of the management issues we raised in previous reports. Specifically, we noted improvements in IRS' (1) overall financial reporting, (2) records of accounts payable, (3) amounts held in suspense, (4) documentation of unpaid tax assessments, (5) reconciliation of fund balance with Treasury, (6) computer security, and (7) handling of taxpayer receipts and data, including courier security. Additionally, and most significantly, IRS senior management has clearly demonstrated a commitment to address the operational and financial management issues discussed in this report. A high level of involvement by IRS senior management has contributed significantly to actions taken to resolve some of the issues we have raised, and continued involvement at this level is critical to IRS' success in addressing the serious problems that remain.

IRS continues to face the pervasive systems and internal control weaknesses we have been reporting each year since we began auditing IRS' financial statements in fiscal year 1992.[2] During fiscal year 1999, IRS focused sub-

[1]See High-Risk Series: An Update (GAO/HR-99-1, January 1999) and Major Management Challenges and Program Risks: Department of the Treasury (GAO/OCG-99-14, January 1999).
[2]Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993)

stantial efforts on developing compensating processes to work around its serious systems and control weaknesses in order to derive year-end balances for its financial statements. These processes and efforts enabled IRS to improve the reliability of its reported year-end information. However, this approach relies heavily on costly, time-consuming processes, statistical projections, external consultants, and monumental human efforts to derive year-end balances due to the lack of reliable financial management and operational systems. More importantly, this approach does not produce the timely and reliable financial and performance information IRS needs for decision-making on an ongoing basis, nor does it address the underlying financial management and operational issues that adversely affect IRS' ability to effectively fulfill its responsibilities as the nation's tax collector. The challenge for IRS in future years will be to build on the improvements made in fiscal year 1999 to not only improve its compensating processes but also to develop and implement the fundamental long-term solutions that are needed to address the management challenges we have identified. Some of these solutions can be addressed in the near term through the continued efforts and commitment of IRS management. Others involve modernization of IRS' financial and operational systems and will take years to fully achieve.

The key issues IRS faces include the following:

- an inadequate financial reporting process, resulting in IRS' inability to reliably prepare several of the required financial statements;
- deficiencies in controls to properly manage unpaid assessments, resulting in both taxpayer burden and potentially billions of dollars in lost revenue to the government;
- deficiencies in controls over tax refunds, permitting the disbursement of potentially billions of dollars of improper refunds;
- the failure to reconcile IRS' fund balance with Treasury records throughout fiscal year 1999, resulting in IRS' inability to routinely ensure accountability and proper use of its funds;
- inadequate systems and controls that resulted in the inability to properly account for IRS' property and equipment and related costs;
- inadequate budgetary controls, resulting in IRS' inability to assure that its budgetary resources are being properly accounted for, reported, and controlled;
- deficiencies in computer security controls that may allow unauthorized individuals to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information;
- deficiencies in controls over hardcopy tax receipts and taxpayer data that increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data;
- deficiencies in revenue reporting and excise tax distributions, resulting in IRS' inability to separately report revenue collected for three of the federal government's four largest revenue sources and errors in quarterly distributions of excise tax revenue to trust funds; and
- noncompliance with selected provisions of the Internal Revenue Code and the Federal Financial Management Improvement Act (FFMIA) of 1996.

These weaknesses, as they relate to IRS' administrative activities, prevented us from rendering an unqualified opinion on five of IRS' six financial statements. Specifically, they resulted in our qualifying our opinion on IRS' balance sheet and disclaiming opinions on the statements of net cost, changes in net position, budgetary resources, and financing. For IRS' custodial activities, we were able to verify that the reported balances were fairly stated, in all material respects, through extensive audit procedures and after tens of billions of dollars of adjustments. IRS' ongoing efforts to modernize its organizational structure and information systems are heading in the right direction.[3] Successful implementation of these long-term efforts and resolution of the serious problems discussed in this report will require substantial resources and expertise.

OPINIONS ON IRS' FINANCIAL STATEMENTS

Our opinion on the statement of custodial activity is unqualified. IRS' Statement of Custodial Activity, including the accompanying notes, presents fairly, in all material respects, in conformity with generally accepted accounting principles, IRS' custodial activity for the fiscal year ended September 30, 1999.

Our opinion on the balance sheet is qualified. Except for limitations on the scope of our work resulting from insufficient evidence about the reliability of the components of net position[4] in Note 11, the balance sheet, including the accompanying notes, presents fairly, in all material respects, in conformity with generally accepted accounting principles, IRS' assets, liabilities, and net position as of September 30, 1999.

We are unable to render opinions on the statements of net cost, changes in net position, budgetary resources, and financing because of limitations on the scope of our work resulting from insufficient evidence about (1) the opening balances of IRS' fund balance with Treasury, property and equipment, accounts payable, and net position,[5] (2) the reliability of program costs and budgetary balances, and (3) the components of net position.

OPINION ON THE EFFECTIVENESS OF IRS' INTERNAL CONTROLS

In our opinion, because of the material weaknesses discussed later in this report, IRS' internal controls at September 30, 1999, were not effective in providing reasonable assurance that (1) government assets and confidential taxpayer information are appropriately safeguarded, (2) laws and regulations material to the financial statements are complied with, and (3) financial accounting and budgetary information reported by IRS is accurate, timely, and meaningful to users.

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[3]See IRS Restructuring Act: Implementation Under Way but Agency Modernization Important to Success (GAO/T-GGD-00-53, February 2, 2000).

[4]Net position comprises the cumulative results of IRS' operations, the value of outstanding orders for goods and services that had not been received at fiscal year-end (undelivered orders), and the unobligated portion of IRS' appropriated funds at fiscal year-end, which includes available and unavailable amounts.

[5]See Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS AND THE REQUIREMENTS OF FFMIA

Our tests of compliance with selected provisions of laws and regulations disclosed two instances of noncompliance with laws and regulations that we consider to be reportable under generally accepted government auditing standards and OMB Bulletin 98-08, as amended, Audit Requirements for Federal Financial Statements. These relate to IRS' structuring of installment agreements to collect delinquent taxes and the timing of the release of tax liens on taxpayers' property. We were unable to test compliance with the Antideficiency Act, as amended,[6] due to the limitations on the scope of our work previously discussed.

Also, we concluded that IRS' financial management systems do not substantially comply with the following requirements of FFMIA, which is reportable under OMB Bulletin 98-08, as amended:

- Federal Financial Management Systems Requirements,
- applicable federal accounting standards, and
- the U.S. Government Standard General Ledger (SGL) at the transaction level.

In its fiscal year 1999 Federal Managers' Financial Integrity Act of 1982 (FIA) assurance statement to the Treasury, IRS also concluded that its financial management systems do not comply with FFMIA. The objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

MATERIAL WEAKNESSES

During our audit of IRS' fiscal year 1999 financial statements, we identified seven material weaknesses[7] in internal controls that may adversely affect any decision by IRS' management that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Similar to our findings and reports from previous audits, we were unable to obtain reasonable assurance that IRS' program costs, budgetary balances, and components of net position were reliable. In addition, unaudited financial information reported by IRS, including budget and performance information, may also contain misstatements resulting from these deficiencies. Some of these material weaknesses have also allowed inappropriate refunds to be paid, reduced IRS' effectiveness in its enforcement of the tax code, and resulted in errors in taxpayer accounts and increased taxpayer burden. The material weaknesses we have identified relate to IRS' controls over (1) the financial reporting process, (2) management of unpaid assessments, (3) refunds, (4) fund balance with Treasury, (5) property and equipment, (6) budgetary activities, and (7) computer security. With the exception of the issue involving budgetary controls, we reported on these issues last year.[8] We discuss these weaknesses in the following

[6]Among other things, the Antideficiency Act, as amended (31 U.S.C. 1341(a)(1)), prohibits officers and employees of the federal government from obligating or expending federal monies in excess of amounts appropriated unless authorized by law.

[7]A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis. Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS' ability to meet the objectives described in this report.

[8]See GAO/AIMD-99-75, March 1, 1999.

sections and plan to provide more details on them, as well as recommendations for corrective actions, in a subsequent report. We will separately report in a management letter to IRS on other less significant matters involving IRS' system of internal controls and its operation.

Financial Reporting

IRS does not have adequate internal controls over its financial reporting process to provide reasonable assurance that its financial statements are fairly presented. As a result, we were unable to determine if the components of IRS' net position, as shown in Note 11, or its statements of net cost, changes in net position, budgetary resources, and financing were reliable. These weaknesses also rendered IRS dependent on extensive and labor-intensive compensating ad hoc procedures to enable it to report reliable (1) revenue and refund balances on its statement of custodial activity and (2) taxes receivable, property and equipment, and accounts payable amounts on its balance sheet. While IRS made significant improvements in the form and content of its financial statements during fiscal year 1999, material weaknesses in its underlying records continued to adversely affect the reliability of the financial statements.

IRS was not able to routinely generate the information needed to prepare its financial statements. IRS' general ledger (1) did not always use the standard federal accounting classification structure, (2) was not current or accurate, and (3) was not supported by adequate audit trails for property and equipment, program costs, federal tax revenue, federal tax refunds, or taxes receivable. Due to these deficiencies, IRS' general ledger was not in conformance with the SGL as required by the Core Financial System Requirements of the Joint Financial Management Improvement Program[9] and FFMIA. Consequently, IRS continued to be unable to rely on its general ledger to support its financial statements.

Unlike fiscal year 1998, IRS was able to provide us with a listing of accounts payable as of September 30, 1999. However, in testing accounts payable, we found that the listing was incomplete and included invalid items. Of 30 items we selected in a statistical sample, 3 (10 percent) were not valid accounts payable. For example, in one case IRS inappropriately included in its fiscal year 1999 accounts payable balance a $200,000 invoice which was received in, and related mostly to services to be rendered in, fiscal year 2000. Also, in testing the completeness of accounts payable, we found that 13 of 66 (20 percent) items selected in another statistical sample were inappropriately excluded from accounts payable. For example, IRS' September 30, 1999, accounts payable listing excluded $2.7 million for lockbox bank services provided from October 1998 through March 1999 that were paid in October 1999. In addition, we found many cases where items shown as undelivered orders had actually been received and should have been recorded as accounts payable.

We also found that the costs of IRS' two largest programs, customer service and compliance, are intermingled on its statement of net cost. The costs reported for these two programs for fiscal year 1999 include amounts for activities that we believe are inconsistent with the nature of the programs. Our testing of payroll transac-

[9]The Joint Financial Management Improvement Program (JFMIP) is a cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO, working in cooperation with each other and with operating agencies to improve financial management practices.

tions found that in accounting for and reporting costs of its compliance activities, IRS included funding for customer service activities such as taxpayer walk-in service and taxpayer education efforts.[10] Similarly, IRS considers all non-face-to-face contact with taxpayers to be forms of customer service, including compliance-related activities such as telephone tax collection and correspondence examinations of tax returns. In a statistical sample of 70 payroll transactions, we found that in 8 cases (11 percent), staff working on activities such as correspondence examinations or telephone tax collections charged all of their time to customer service. Consequently, IRS is unable to reliably report to the Congress or the public the appropriate information on the cost of either of its two largest programs. For this and other reasons discussed in this report, IRS is unable to generate reliable cost-based performance measures related to either of these programs consistent with the Government Performance and Results Act of 1993.

IRS' financial statements are affected by material amounts that are either not recorded in the general ledger until the subsequent year or not recorded in its general ledger at all. As a result, IRS' general ledger is perpetually materially incomplete. Consequently, the general ledger must be supplemented by extensive analysis and material adjustments intended to recognize transactions that were omitted from the general ledger. These supplemental procedures are costly, labor intensive, prone to error, and typically require several months to complete. This approach also requires effective internal controls if it is to produce reliable information. However, IRS did not effectively supervise this process to ensure that errors are caught and corrected before they adversely affect the financial statements. For example, we found material discrepancies in IRS' opening general ledger balances for fiscal year 1999, which we brought to IRS' attention. In researching these discrepancies, IRS found financial reporting adjustments totaling over $51 million that were erroneously recorded. If uncorrected, these errors would have caused a misstatement in the financial statements of more than $102 million. IRS did not detect these errors because supervisory reviews of financial reporting adjustments were ineffective. As a result of these problems, IRS cannot produce reliable agencywide financial statements or financial performance information throughout the year as a management tool, as is standard practice in private industry and some federal entities.

Management of Unpaid Tax Assessments

During fiscal year 1999, we found that serious internal control issues continued to affect IRS' management of unpaid assessments. The lack of an effective subsidiary ledger; errors and delays in recording assessments, payments, and other activities; and the failure to actively pursue significant amounts in outstanding taxes owed to the federal government hinder IRS' ability to effectively manage unpaid assessments and maximize collections.

IRS continues to lack a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status[11] on an ongoing basis. The lack of such a subsidiary ledger renders IRS unable to promptly identify and focus collection efforts on accounts most likely to prove collectible[12] and impedes its ability to

[10]See Tax Administration: IRS' Fiscal Year 1999 Budget Request and Fiscal Year 1998 Filing Season (GAO/T-GGD/AIMD-98-114, March 31, 1998).

prevent or detect and correct errors in taxpayers' accounts. Additionally, IRS records continued to contain errors and IRS continued to experience significant delays in recording activity in taxpayer accounts. We found that these conditions resulted in instances of unnecessary taxpayer burden and lost opportunities to collect outstanding taxes owed. During our audit, we found the following:

- Significant delays-in some instances in excess of 10 years-in recording payments made by taxpayers to related taxpayer accounts. We also found payments that were not recorded at all in related taxpayer accounts. Some of these delayed or unrecorded payments were made in the late 1980s.
- Delays in making or recording assessments against taxpayers. In some instances, these delays resulted in lost opportunities for IRS to offset refunds owed to taxpayers for subsequent tax periods against their outstanding tax liabilities. In one case, an individual received a $15,000 refund at the same time that IRS identified this individual as owing nearly $350,000 in outstanding taxes. However, the tax assessment was not recorded in IRS' systems until nearly 9 months later.
- Delays in correcting erroneous assessments resulting from data input errors. In one case, it took 18 months for IRS to correct an input error that resulted in an erroneous assessment of over $160,000 against a taxpayer who was actually due a refund. The case file indicated that IRS personnel believed the assessment was erroneous 10 months before correcting the account.

The unpaid assessment accounts demonstrating these issues most frequently were those representing unpaid payroll taxes, where separate accounts are established and assessments recorded for a related tax liability.[13] IRS' current systems cannot automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer pays some or all of the outstanding taxes, IRS' systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In 35 of the 78 (45 percent) unpaid payroll tax cases we reviewed involving multiple assessments, we found that payments were not accurately recorded to reflect each responsible party's reduction in tax liability. IRS has attempted to compensate for the lack of an automated link between related accounts by manually inputting a code in each account that cross-references it to other related accounts. However, this cross-referencing process has thus far had limited success in reducing the extent of inaccuracies in taxpayer accounts.

We also identified many instances in which accounts that appeared to have some collection potential were not being actively pursued by IRS. These accounts had been designated by IRS as "currently not collectible." Until recently, this designation was typically used for cases in which the taxpayer owing the outstanding taxes was experiencing financial difficulties or other hardships that made collection highly unlikely. During

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[11]Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 1999, IRS reported $21 billion (net of an allowance for doubtful accounts of $56 billion), $27 billion, and $127 billion in these three categories, respectively.

[12]It should be noted that although certain taxpayer accounts have little likelihood of collection, IRS would generally continue some collection efforts to reinforce continued compliance by those taxpayers who appropriately report and pay their tax obligations and to increase compliance by taxpayers who are delinquent in reporting and paying their tax obligations.

[13]When a company does not pay the taxes that have been withheld from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess the responsible officers individually for the taxes withheld from employees. Thus, IRS may record the assessments against each of several individuals for the employee withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. While the assessments made against business officers-known as trust fund recovery penalties-are a necessary enforcement tool, IRS should only collect the unpaid tax once.

fiscal year 1999, however, IRS modified the criteria under which unpaid assessment cases could be designated as currently not collectible in response to an increasing inventory workload and its judgment that resource constraints would not permit the agency to actively pursue the cases. There is a point at which it ceases to be cost effective to pursue collection, and clearly many cases in our sample provided little or no hope of future collections. However, for numerous cases, information in the case files indicated that the taxpayer had financial resources available to pay at least some of the amounts owed, yet these cases were not being actively pursued. Additionally, in one case, IRS had seized property owned by a taxpayer who owed over $4 million in outstanding taxes and was in the process of auctioning it off to collect on at least a portion of these taxes, yet for no reasonable explanation, IRS pulled the property from auction and later returned it to the taxpayer. IRS' failure to pursue certain taxpayers owing taxes to the federal government could result in billions of dollars in outstanding amounts going uncollected and adversely affect future compliance.

There has been a long-standing problem with inadequate documentation for unpaid assessment cases in which we noted substantial improvement in fiscal year 1999. Many of the cases we reviewed this year contained detailed information that greatly assisted in determining both the appropriate classification of the unpaid assessment and a basis for estimating collectibility for those cases determined to be taxes receivable. While there continued to be a lack of documentation on non-estate installment agreement cases, and there were other cases in which transcripts of taxpayers' accounts were the only documentation IRS could provide, the overall level of documentation has greatly improved over previous years.

Controls Over Refunds

IRS does not have adequate controls to sufficiently reduce the risk of inappropriate tax refunds being made. IRS does have detective (post-refund) controls in place, but they are not applied to millions of tax returns estimated to have billions of dollars of underreported tax liabilities. In addition, IRS' investigators identified nearly $16 million in potentially fraudulent refunds that had been disbursed during the first 9 months of calendar year 1999 and prevented the disbursement of an additional $498 million in potentially fraudulent refund claims. The full magnitude of invalid refunds disbursed by IRS is unknown but could be in the billions of dollars. While IRS recognizes that taxpayers often submit erroneous and, in some cases, fraudulent refund claims, IRS does not have adequate (1) preventive controls to stop disbursements of invalid refunds or (2) detective controls to identify invalid refunds that have been disbursed so that collection efforts may be pursued. IRS does not (1) compare the information on tax returns to third party data such as W-2s (Wage and Tax Statement) in time to identify and correct discrepancies between these documents before issuing refunds, (2) always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims before they result in refunds, (3) always post assessments to taxpayer accounts in a timely manner, and (4) have adequate controls to prevent duplicate refunds from being issued. These conditions expose the government to potentially significant losses due to inappropriate refund disbursements.

IRS has indicated that it does not compare tax returns to W-2s and 1099s at the time tax returns are processed because this (1) is not practical due to the intensive labor involved in performing such comparisons on the high volume of tax returns received and (2) would adversely affect IRS' ability to promptly process tax returns and issue refunds.[14] Consequently, to perform these comparisons, IRS relies instead on automated programs, which are run months later, with subsequent follow-up on some identified differences serving as a compensating detective control. However, in addition to these programs being run too late to prevent issuance of erroneous or fraudulent refunds, we also found significant gaps in their effectiveness as a detective control. For tax year 1996,[15] IRS' matching program for individual taxpayers screened about 155 million individual income tax returns and found that about 12 million (8 percent) had potential underreported taxes due totaling at least $15 billion. However, IRS investigated only about 3.1 million (26 percent) of these tax returns, accounting for estimated underreported taxes due of about $5.2 billion (35 percent). In addition, IRS did not investigate any of the more than 688,000 discrepancies found by its matching program for employment tax returns filed by employers during fiscal year 1996. According to IRS, resource constraints precluded them from investigating more of these discrepancies and the related estimated underreported taxes due. The full magnitude of unpaid taxes contained in the tax returns IRS found to contain discrepancies but did not investigate is unknown. Additionally, as discussed previously, to the extent IRS does not actively pursue collection of the cases identified in its matching program for which it assesses additional taxes, the effectiveness of this process is further diminished.

Historically, EITCs have been vulnerable to high rates of invalid claims.[16] Since most EITCs result in refunds,[17] this significantly increases the risk of invalid refunds being disbursed. In an effort to minimize this, IRS relies on past experience to screen tax returns claiming EITCs to identify (for detailed examination) those EITC claims considered most likely to be invalid. During fiscal year 1999, IRS examiners using this screening process examined about 573,000 tax returns claiming $1.25 billion in EITCs and found that $1.08 billion (86 percent) were invalid. These examinations are an important control mechanism for detecting questionable claims and deterring future invalid claims. However, because they are often performed after any related refunds are disbursed, examinations cannot substitute for effective preventive controls designed to identify invalid claims before the disbursement of refunds. The magnitude of refunds resulting from invalid EITCs is unknown. In fiscal year 1998, IRS began implementing a 5-year EITC compliance initiative intended to address noncompliance problems with EITCs. IRS is in the process of evaluating the effectiveness of its initiative. However, the high rate of invalid EITC claims found during IRS examinations suggests that invalid EITC claims continue to be significant.

As previously discussed, we also found instances where inappropriate refunds were issued as a result of delays in recording tax assessments to taxpayers' accounts. IRS is also vulnerable to issuance of duplicate refunds allowed by gaps in its internal controls. IRS' manual and automated systems are not properly coordinated to prevent identical refunds from being processed through both systems, and controls designed to compensate for this are not always effective.

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[14]By statute, IRS must pay interest on refunds not paid within 45 days of receipt or due date, whichever is later {26 U.S.C. 6611}.

[15]Tax year 1996 is the most recent year for which substantially complete matching program results are available.

[16]See GAO/HR-99-1, January 1999; GAO/OCG-99-14, January 1999; and GAO/AIMD 99-75, March 1, 1999.

[17]During fiscal year 1999, IRS processed about $30 billion in EITCs. Of this amount, about $26 billion (87 percent) was refunded, and the rest reduced tax assessments.

Fund Balance With Treasury

Despite substantial efforts, IRS was unable to reconcile its administrative fund balance with Treasury accounts[18] throughout fiscal year 1999. We were able to conclude that the amount reported as fund balance with Treasury on IRS' balance sheet was fairly stated in all material respects at September 30, 1999. However, unresolved reconciling items continue to raise serious questions about IRS' ability to ensure that its operating funds are being properly spent and that it complies with the laws governing its use of budget authority. Treasury policy and prudent financial management practices require an agency to routinely reconcile its fund balance with Treasury accounts to Treasury's records. These reconciliations would identify differences between IRS' and Treasury's records. Resolution of such differences would involve adjustments to either IRS' records, Treasury's records, or both. This process is similar to companies or individuals reconciling their checkbooks to a monthly bank statement.

IRS attempted to reconcile its beginning fiscal year 1999 fund balance with Treasury's records as well as its balance at both March and June 1999. However, IRS was unable to adequately reconcile these periods due to its inability to correct its records for unsupported adjustments of approximately $84 million and $60 million recorded to its general ledger in fiscal years 1997 and 1998, respectively, to force its records to match Treasury's records.[19] These adjustments represented an accumulation of unidentifiable differences between Treasury's and IRS' records. IRS had posted these adjustments for several years without first performing the necessary research to determine whether adjustments were, in fact, needed to the general ledger or whether some or all of these differences were attributable to errors in Treasury's records. This is similar to an individual not reconciling his or her checkbook with monthly bank statements for years, and then adjusting the checkbook to agree with the balance per the latest bank statement without first verifying that the bank had not made any mistakes. Because some of the adjustments IRS had made related to differences going back as far as fiscal year 1995, IRS' ability to research and make proper correcting entries was further hindered. IRS had to devote significant time and staff resources to try to correct its records for the effects of these adjustments.

IRS provided us with several versions of a fiscal year-end reconciliation. However, we found that these reconciliations were not adequate because they (1) omitted 3 of the 43 appropriation accounts that comprise IRS' fund balance with Treasury, (2) contained numerous errors, (3) did not fully support how IRS resolved the prior years' unsupported adjustments, and (4) contained numerous unsupported reconciling items resulting from the National Finance Center's (NFC)[20] reporting to Treasury IRS payroll expenses charged to appropriations that were different from what IRS had recorded. It was not until late January 2000 that IRS was able to furnish additional explanations and support for how it resolved the prior years' unsupported adjustments, as well as correct its reconciliation schedules for errors we identified. This was a substantial improvement over last year and thus enabled us to conclude that IRS' fund balance with Treasury was reliable at September 30,

[18] Like other agencies, IRS records administrative budget spending authorizations in the asset account titled "fund balance with Treasury." The funds maintained in this account are used to fund IRS' operations. IRS' fund balance with Treasury account is composed of 43 appropriation accounts, which IRS increases or decreases as they receive or disburse funds.

[19] The problems related to adjusting agency records to match the amounts reported by Treasury have been noted in other GAO reports. See Financial Audit: Issues Regarding Reconciliations of Fund Balance With Treasury Accounts (GAO/AIMD-99-271, September 1999).

[20] The National Finance Center processes IRS' payroll and reports the expense amounts associated with the payroll to IRS for accounting purposes.

1999. However, reconciling differences between IRS and Treasury records related to payroll continue to exist. Such differences need to be fully researched to determine the extent to which the appropriation accounts that comprise IRS' fund balance may be misstated and in need of further adjustments. These unresolved differences and IRS' lack of routine and complete reconciliations raise serious concerns about its ongoing ability to ensure that it complies with the law governing the use of its budget authority. Without this crucial control, it is difficult, if not impossible, for IRS to determine if operating funds are being properly spent or if reported amounts for program costs, assets, and liabilities are reliable.

Property and Equipment

IRS has seriously flawed systems and controls over its property and equipment (P&E). As a result, IRS is unable to rely on its P&E subsidiary records to account for or report its inventory of P&E assets in accordance with federal accounting standards.[21] IRS does not have an integrated property management system that appropriately records P&E additions and disposals as they occur. Instead, IRS expenses property purchases during the year, then records adjustments at year-end to reflect P&E dispositions and to move property purchases from expenses to P&E based on subsidiary records maintained at field offices. However, these subsidiary records are unreliable because IRS' procedures to ensure that P&E purchases and disposals are properly recorded in subsidiary records are not consistently followed. In addition, as a result of these inaccurate records, IRS' Chief Information Officer found it necessary to conduct a comprehensive and costly inventory of computer equipment and software to ensure that all of IRS' critical systems were identified and made year 2000 compliant.

As in prior years, we continued to find significant errors in the quantities and valuations of P&E included in IRS' P&E subsidiary records in fiscal year 1999. These errors are the result of ineffective IRS procedures to capture additions and disposals of P&E. Specifically, IRS relies on individuals across the country to inform those responsible for maintaining the subsidiary records of any P&E additions or disposals. For example, at one IRS location we visited, the procedure for updating the P&E records for property purchases consisted of the individual receiving the property making a long distance telephone call to another individual responsible for recording the acquisition in the P&E subsidiary records. We found that procedures for recording P&E frequently were not followed, resulting in numerous errors. For example, we found that of 106 P&E items we inventoried at IRS field offices, 27 (25 percent) were not included in the P&E records, including videoconferencing equipment and three recently acquired mail-sorting machines that cost over $800,000 each. We also noted that 200 personal computers that had been disposed of were still included in IRS' records. In addition, we found that P&E was consistently recorded based on internal documents such as purchase orders or requisitions that may not reflect the actual invoice price paid and that, contrary to federal accounting standards, shipping and installation costs were excluded from the recorded value. We found other valuation errors in IRS' records including a Compaq laptop computer recorded at a cost of $310,000 and a copy of Microsoft Office software that cost $212 but was erroneously recorded at $212,300.

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[21]Statement of Federal Financial Accounting Standards (SFFAS) No. 6, Accounting for Property, Plant, and Equipment.

For its September 30, 1999, P&E balance, IRS determined that it could not rely on its records and, as allowed by federal accounting standards, developed a balance based primarily on a statistical estimate by a consulting firm. IRS' estimate of $1.3 billion of net P&E at September 30, 1999, resulted in an upward adjustment of over $1 billion (600 percent) to IRS' accounting records. This substantial adjustment confirmed our fiscal year 1998 conclusion that IRS' P&E balance was likely materially understated. In addition to the problems previously discussed, this substantial adjustment was necessary because IRS excluded over $250 million of external software and systems development costs and $65 million of assets under capital lease. The material adjustment to IRS' P&E balance was also necessary because IRS' prior practice of using Treasury's capitalization threshold of $50,000 was inappropriate. The use of this threshold in the past resulted in hundreds of millions of dollars in P&E purchases being expensed in the year of purchase instead of being properly capitalized as assets in IRS' financial reports.

While IRS' costly and time-consuming effort did produce a reasonable P&E balance at year-end, IRS' statements of net cost, changes in net position, and financing continued to be adversely affected by IRS' inability to distinguish P&E asset purchases from expenses or to reliably report depreciation expense. IRS has reported a material weakness in P&E internal controls in its FIA assurance statement to Treasury every year since 1983. Before IRS undertook its costly year-end estimate of P&E, we recommended to management that it ensure that systems and controls be in place for fiscal year 2000 to properly record additions and disposals of P&E. If IRS does not implement needed improvements for fiscal year 2000, it will have spent over $1 million on an estimate that was reliable for only 1 day and may be unable to properly account for the billions of dollars it plans to spend on tax systems modernization over the next decade.

Budgetary Controls

IRS' internal controls are inadequate to provide reasonable assurance that the budgetary balances reported on its financial statements are reliable or that its obligations do not exceed budgetary resources. As a result, we were unable to determine whether the components of net position shown in Note 11 to the financial statements were reliable. We found obligations still recorded that should have been deobligated and unexpended appropriations that should have been recorded as expended. In addition, IRS does not promptly record expenditures against appropriations for payments made automatically through Treasury. IRS does not have current, accurate budgetary information and reliable budgetary controls to successfully manage operations on an ongoing basis and to ensure that resources are expended only in accordance with established authority.

In our testing of a statistical sample of 130 undelivered orders[22] at September 30, 1999, we found errors in 55 cases (42 percent). Specifically, we found undelivered orders dating back as far as 1996 that IRS should have deobligated. For example, we found $2.8 million for an undelivered order relating to computer services for which the last invoice was received in fiscal year 1996 but the remaining unneeded amount had not been deobligated. Also, we found several instances in which goods or services had been delivered but the amount was not removed from IRS' undelivered orders. For example, we found fiscal year 1999 telephone services for approximately $2 million that were not recorded as expenses and reductions of undelivered orders. In another

[22]Undelivered orders represent the value of goods and services ordered that have been obligated but have not been received.

instance, we found $2.2 million of computer services that had been received prior to September 30, 1999, but were still shown as an undelivered order. These overstatements of undelivered orders resulted in understatements of IRS' accounts payable.

In addition, IRS' automated controls over the use of its budgetary resources were not effective. Specifically, IRS allowed excessive numbers of individuals to have the capability to override its automated spending controls. We found that 1,332 (76 percent) of the 1,749 users that had access to IRS' budgetary control system had some capabilities to override controls, which could allow expenditures to exceed amounts obligated. Also, 87 of these individuals had the ability to override appropriation-level spending controls, which could allow expenditures to exceed amounts appropriated. Additionally, IRS did not promptly record all expenditures in the accounts of the appropriations authorized to pay them. Instead, for some expenditures for which the funding information and/or supporting documentation was incomplete, IRS recorded the transactions in suspense accounts while awaiting supporting documentation. IRS made substantial improvements in its handling of suspense items and was able to reduce the amount held in suspense from more than $140 million at September 30, 1998, to about $8 million at September 30, 1999. However, transactions continue to remain in suspense for a number of months or longer. For example, IRS still had a number of charges from the General Services Administration that were recorded in its suspense account in 1996, including one for $740,000 that was recorded in November 1996 and still had not been charged to an IRS appropriation. Until these suspense transactions are posted to the proper appropriation accounts and matched with corresponding obligation records, IRS cannot ensure that its outstanding obligations and disbursements do not exceed appropriated amounts.

Computer Security

IRS made a lot of progress in improving computer security at its facilities and corrected a significant number of the computer security weaknesses identified in our previous reports. In addition, IRS established and is implementing a servicewide computer security planning and management program that should, when fully implemented, help IRS effectively manage its computer security risks. As part of its effort to implement this program, IRS is updating its access control standards to reflect changes in technology and operating environments, providing computer security training to personnel, and conducting computer security self-assessment reviews that identify and mitigate vulnerabilities on a proactive basis.

At the same time, much remains to be done to resolve the significant control weaknesses that exist within the IRS computing environment. IRS places extensive reliance on computer information systems to perform basic functions such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. These computer control weaknesses could impair IRS' ability to perform these vital functions and increase the risk of the unauthorized disclosure, modification, or destruction of taxpayer data.

We found that IRS continued to have serious weaknesses with general controls designed to protect computing resources such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. Such computing resources also include systems operated and maintained by other government entities, such as Treasury's Financial Management Service. IRS did not always (1) effectively implement controls to prevent, limit, or detect access to computing resources, (2) adequately segregate system administration and security administration responsibilities, (3) optimally configure system software to ensure the security and integrity of system programs, files, and data, (4) sufficiently plan or test the activities required to restore critical business systems when unexpected events occur, and (5) routinely monitor key networks and systems to identify unauthorized activities and inappropriate system configurations. In addition, internal controls over IRS' key computer applications that manage budget execution, tax return input, and receipt processing do not provide adequate assurance that only authorized personnel have access to the application and related data, that the data are complete and accurate, and that application and data integrity is maintained.

These weaknesses increase the risk that data processed by IRS' computer systems is not reliable. If IRS does not adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or computer programs. Such individuals could also obtain personal taxpayer information and use it to commit financial crimes in the taxpayer's name (identity fraud), such as fraudulently establishing credit and running up debts.

REPORTABLE CONDITIONS

In addition to the material weaknesses discussed above, we identified two reportable conditions which, although not material to the financial statements, represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS' ability to meet the internal control objectives described in this report. These conditions concern weaknesses in IRS' (1) internal controls over manually processed tax receipts and taxpayer information and (2) revenue reporting and distribution process. We reported on both issues in prior years.[23]

Manual Tax Receipts and Taxpayer Information

Although some improvements have been made, IRS continues to have weaknesses in controls designed to safeguard cash, checks, and related hardcopy taxpayer data it manually receives from taxpayers. These weaknesses expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. Although we do not consider these to be material weaknesses, it is important that corrective action be taken because these issues are critical to IRS' successfully meeting its customer service goals.

Specifically, for fiscal year 1999, we found that IRS employed individuals to process cash, checks, and other taxpayer data before receiving satisfactory results of fingerprint checks. At the seven service centers that reported data, 4,835 employees that were hired to process taxpayer receipts or data for the 1999 filing season entered on duty before their fingerprint checks were completed. Fingerprint check results for 138 (3 percent)

[23]See GAO/AIMD-99-75, March 1, 1999.

of these employees later disclosed unsuitable backgrounds. Of the 138 employees, the backgrounds of 65 (47 percent) were considered severe enough to result in their termination or forced resignation from IRS. We also identified other weaknesses, including returned refund checks that were not immediately voided or locked up as required by IRS policy and service center guards and staff that did not ask a courier for identification before he entered the service center or before they handed him a $28 million deposit, even though he was not the regular courier. We found that similar weaknesses existed at commercial lockbox banks IRS contracted with to process tax receipts, including the hiring of temporary employees to handle taxpayer receipts and other data before receiving satisfactory fingerprint results.

These weaknesses increased IRS' vulnerability to theft or loss. For example, in fiscal year 1999, IRS identified 37 actual or alleged employee thefts of receipts at IRS field offices and lockbox banks totaling over $1 million. An additional 8 cases were opened during the period in which the amount potentially stolen was not quantified because the investigations were still ongoing and the thefts had not yet been verified, or the stolen checks were never negotiated. Furthermore, the magnitude of thefts not identified by IRS is unknown. IRS has taken action to address some of the control deficiencies related to tax receipts and taxpayer data we have reported in prior years. For example, IRS eliminated the use of bicycle or foot couriers to transport deposits to financial institutions and issued enhanced courier security procedures after year-end. Also, unauthorized personnel, such as security guards, are now prohibited from accepting tax payments at service centers. We will continue to follow up in future audits to assess the effectiveness of IRS' corrective actions.

Revenue Reporting and Distribution

IRS continues to be unable to determine the specific amount of revenue it actually collects for Social Security, Hospital Insurance, Highway, or other relevant trust funds. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the return pertains only to the amount of the tax liability, not to the distribution of the amount previously collected. As a result, IRS cannot report the specific amount of revenue it actually collected for three of the federal government's four largest revenue sources, including Social Security, Hospital Insurance, and individual income taxes.

Because collection data are not available to allocate excise taxes to the appropriate trust funds when deposits are made, Treasury's Office of Tax Analysis uses economic models to estimate the initial distribution of excise tax receipts. Six months later, IRS certifies quarterly the amounts to be distributed to the excise tax-related trust funds using its records of payments received and the subsequently provided tax returns. This certification process is complex, cumbersome, and prone to error. As a result, weaknesses in fundamental internal controls, such as the lack of written procedures and inadequate supervisory review, allowed errors in the certification process to occur and not be detected. This, in turn, directly affected the distribution of revenue to the trust funds. These weaknesses included (1) taxpayer errors on excise tax returns which IRS did not identify, (2) errors made by IRS when recording excise tax information to its master files, and (3) errors in IRS' preparation of the excise tax certifications. Although IRS implemented additional review procedures over its certification process in response to our previous reports, errors continued to exist. For example, we found one error that overstated the gross total certified excise tax collections by approximately $17.5 million and another that understated the certified refunds for the Highway Trust Fund by approximately $8 million. Additionally, we continued to find delays in posting tax returns that resulted in IRS omitting collections from certifications for a given quarter. For example, the amount IRS certified to the Highway Trust Fund for the quarter ended March 31, 1999, included nearly $700 million in collections from previous quarters.

In response to our previous reports, IRS studied whether it should require taxpayers to provide detailed information on the type of tax when they pay their taxes. The study showed that taxpayers could easily provide this information for Social Security and Hospital Insurance taxes. However, the study showed that it was potentially burdensome for taxpayers to provide this information for excise taxes and that the quality of this information at the time of deposit is likely to be poor. Additionally, IRS officials stated that their current systems cannot capture the additional detailed information. Consequently, IRS is working on developing a payment information database to accommodate this type of information in the future and plans to initiate another study in 3 to 4 years to gauge taxpayer readiness at that time. However, until IRS has the systems capability to record, and requires taxpayers to provide, specific information on the type of taxes being paid at the time of payment, it will continue to be unable to report revenue actually collected for three of the federal government's four largest revenue sources and continue to employ a process for distributing excise tax revenue to trust funds that is susceptible to errors.

NONCOMPLIANCE WITH LAWS AND REGULATIONS AND FFMIA REQUIREMENTS

As discussed above, limitations on the scope of our work prevented us from testing compliance with the Antideficiency Act. Otherwise, our tests of compliance with selected provisions of laws and regulations disclosed two instances of noncompliance that are reportable under generally accepted government auditing standards and OMB Bulletin 98-08, as amended. These relate to IRS' structuring of installment agreements to collect delinquent taxes and timing of the release of federal tax liens against taxpayers' property. We also found that IRS' financial management systems do not substantially comply with the requirements of FFMIA. While the issue involving the release of federal tax liens is new, we reported on installment agreements last year.[24]

IRS' Structuring of Installment Agreements Did Not Comply With the Internal Revenue Code

Section 6159 of the Internal Revenue Code authorizes IRS to enter into installment agreements with taxpayers to satisfy the taxpayer's liability. During our previous audit, we identified numerous instances in which IRS entered into installment agreements with payments and terms that would not be sufficient to satisfy the

[24] See GAO/AIMD-99-75, March 1, 1999.

taxpayers' outstanding tax liability, including future interest accruals, before the statutory collection period for these tax liabilities expires.[25] Consequently, IRS continued to be noncompliant with Section 6159 of the Internal Revenue Code during fiscal year 1999.

In March 1998, IRS' Deputy Commissioner (Collections) issued a memorandum stating clearly that for any new installment agreement, the taxpayer must fully satisfy his/her tax liability. This memorandum was followed in August 1998 by a memorandum from the Chief Operations Officer issuing guidelines on installment agreements pending updates to the Internal Revenue Manual. However, these guidelines were not consistently followed. During our fiscal year 1999 audit, we continued to identify unpaid assessment cases involving installment agreements whose payment terms will not result in full payment of the outstanding taxes. Specifically, of 40 unpaid assessment cases involving installment agreements entered into between taxpayers and the IRS in fiscal year 1999, three (8 percent) contained payment terms that will be insufficient to satisfy the full tax liability before the statutory collection period for these tax liabilities expires. For example, in one case, the taxpayer entered into an installment agreement covering five separate tax periods with a total outstanding balance of $115,000. However, only $43,000 (37 percent) would be collected prior to the expiration of the statutory collection periods for these tax liabilities, assuming the taxpayer continues to make the payments through the statutory collection period.

IRS Did Not Release Federal Tax Liens in Accordance With the Internal Revenue Code

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located. The lien serves to protect the interest of the federal government and serves as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under Section 6325 of the Internal Revenue Code, IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable.

However, in our testing of 23 tax cases in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 1999, we found 6 instances (26 percent) in which IRS did not release the applicable federal tax lien within the 30-day requirement stipulated in the Internal Revenue Code. In one case, we found that the taxpayer had paid off his three outstanding tax liabilities by October 1998; however, as of December 1999-14 months later-IRS had not filed the necessary information to formally release the lien against the taxpayer's property. Our findings are consistent with a report issued by IRS' internal auditors, which cited a high rate of tax liens that were not being released by IRS in a timely manner.[26] The failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

[25]The statutory collection period for taxes is generally 10 years from the date of the tax assessment. However, this period can be extended by agreement with the taxpayer.
[26]Controls for Ensuring That Federal Tax Liens are Promptly Released in the Northeast Region, Report No. 682302, September 8, 1998.

IRS' Financial Management Systems Are Not in Compliance With FFMIA

In fiscal year 1999 we continued to find that IRS' financial management systems did not substantially comply with the Federal Financial Management Systems Requirements (FFMSR),[27] federal accounting standards, and the SGL at the transaction level. We found that although required to do so under FFMSR, IRS (1) cannot reliably prepare four of the six financial statements required by OMB Bulletin 97-01, as amended, (2) does not have a general ledger that conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, (4) lacks a reliable subsidiary ledger for its property and equipment, and (5) lacks an effective audit trail from its general ledger back to subsidiary detailed records and transaction source documents. Other material weaknesses we discussed earlier-controls over refunds, property and equipment, payroll, budget, and computer security-are also conditions indicating that IRS' systems do not comply with FFMSR. As a result, IRS cannot routinely produce auditable financial statements and related disclosures in conformance with federal accounting standards. These weaknesses also indicate that IRS cannot accumulate and report the full costs of its activities on a regular basis as required by SFFAS No. 4. Since IRS' systems do not comply with FFMSR, federal accounting standards, and the SGL, they also do not comply with OMB Circular A-127, Financial Management Systems. In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with FFMIA in fiscal year 1999.

In December 1999, IRS updated its FFMIA noncompliance remediation plan. This plan was designed to address reported material weaknesses in IRS' unpaid assessments, refunds, property and equipment, and accounting for liabilities and accrued expenses. However, the implementation of some improvements is years away. Also, it is not clear whether the plan fully addresses some weaknesses we previously identified. For example, the plan does not specifically address the lack of (1) a general ledger that complies with the SGL or (2) the ability to report cost accounting information. Also, the plan does not address weaknesses in controls over IRS' budgetary resources. Although the plan does not address weaknesses in IRS' computer information systems, IRS has developed a program that should, if properly implemented, help it effectively manage its computer security risks.

SIGNIFICANT MATTER

We identified a significant matter that we believe should be brought to the attention of users of IRS' financial statements and other financial reports. This matter concerns the subsidizing of the Social Security and Hospital Insurance Trust funds by general fund tax revenues. We reported on this matter in prior years.[28]

[27] FFMSR are a series of requirements produced by the JFMIP to improve federal financial management through uniform requirements for financial information, financial systems, and financial organization.

[28] See GAO/AIMD-99-75, March 1, 1999.

Social Security and Hospital Insurance Are Subsidized by General Fund Revenues

Taxes collected on behalf of the federal government are deposited in the general revenue fund of the Department of the Treasury, from which they are subsequently distributed to the appropriate trust funds. Amounts representing Social Security and Hospital Insurance (payroll) taxes are distributed to their respective trust funds based on employee wage information certified by the Commissioner of the Social Security Administration (SSA). Consistent with the statutory verification process, the Commissioner bases this certification on a consideration of both wage information maintained by SSA and wage information provided by IRS.

Because the distribution of the Social Security taxes IRS collects from employers is based on this certification rather than actual collections, the federal government's general fund revenues subsidize the Social Security and Hospital Insurance trust funds. This subsidy occurs primarily because a significant number of employers that file payroll tax returns for Social Security and Hospital Insurance taxes never actually pay the assessed amounts.[29] Many of these businesses ultimately go bankrupt or otherwise out of business. Also, a significant number of self-employed individuals do not pay the assessed amounts. As of September [30], 1999, we estimate that the amount of unpaid taxes and interest in IRS' unpaid assessments balance was approximately $43 billion for Social Security and Hospital Insurance.30 While these totals exclude amounts that are no longer in the unpaid assessments balance due to the expiration of the statutory collection period,[31] they nevertheless indicate the cumulative amount of the subsidy provided from the general fund.

CONSISTENCY OF OTHER INFORMATION

IRS' management discussion and analysis, supplemental information, and other accompanying information contain various data, some of which are not directly related to the financial statements. We did not audit and do not express an overall opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on our limited work, we found no material inconsistencies with the financial statements. However, given the severity of the issues raised earlier with respect to accounting, reporting, and internal controls, such comparisons may not be meaningful. Under OMB Bulletin 97-01, as amended, agencies are asked to (1) strive to develop and report objective measures that, to the extent possible, provide information about the cost-effectiveness of its programs and (2) link these measures to the programs presented in the statement of net cost starting with plans and reports for fiscal year 1999. However, we found that IRS cannot report reliable cost-based performance measures relating to its various programs in accordance with the Government Performance and Results Act of 1993.

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[29]We recently reported in detail on this issue. See Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed (GAO/AIMD/GGD-99-211, August 2, 1999).

[30]We included interest accrued in these amounts because assessments distributed to the trust funds earn interest at Treasury-based interest rates, similar to IRS' interest accruals.

[31]As noted earlier, the statutory collection period for collecting taxes is generally 10 years from the date of the tax assessment. However, this period can be extended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS' records for decades.

OBJECTIVES, SCOPE, AND METHODOLOGY

Management is responsible for (1) preparing the annual financial statements in conformity with generally accepted accounting principles, (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that the broad control objectives of FIA are met, and (3) complying with applicable laws and regulations and FFMIA requirements.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles and (2) internal accounting and financial reporting controls are effectively designed and operating to achieve the following control objectives established under FIA and OMB Circular A-123, Management Accountability and Control:

- Financial reporting-transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with generally accepted accounting principles and safeguarding of assets against loss from unauthorized acquisition, use, and disposition.
- Compliance with laws and regulations-transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other applicable laws, regulations, and governmentwide policies identified by OMB in Bulletin 98-08, appendix C, as amended.

We are also responsible for testing compliance with selected provisions of laws and regulations that have a direct and material effect on the statements; with laws for which OMB Bulletin 98-08, as amended, requires testing; and with FFMIA requirements. Additionally, we are responsible for performing limited procedures with respect to certain other information appearing in these annual financial statements.

Except as discussed above, in order to fulfill these responsibilities, we (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements, (2) assessed the accounting principles used and significant estimates made by management, (3) evaluated the overall presentation of the financial statements, (4) obtained an understanding of internal controls related to financial reporting (including safeguarding assets) and compliance with laws and regulations (including the execution of transactions in accordance with budget authority), (5) tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls, (6) considered compliance with the process required by the Federal Managers' Financial Integrity Act for evaluating and reporting on internal controls and financial management systems (7) tested compliance with selected provisions of the following laws and regulations: Agreements for Payment of Tax Liability in Installments (26 U.S.C. º 6159); Release of Lien as Discharge of Property (26 U.S.C. º 6325); Interest on Underpayment, Nonpayment, or Extension of Time for Payment of Tax (26 U.S.C. º 6601); Interest on Overpayments (26 U.S.C. º 6611); Determination of Rate of Interest (26 U.S.C. º 6621); Failure to File Tax Return or to Pay Tax (26 U.S.C. º 6651); Failure by Individual to Pay Estimated Income Tax (26 U.S.C. º 6654);

Failure by Corporation to Pay Estimated Income Tax (26 U.S.C. º 6655); Civil Service Reform Act of 1978 {5 U.S.C. º5332}; Fair Labor Standard Act of 1938, as amended {29 U.S.C. º206}; Civil Service Retirement Act of 1930, as amended {5 U.S.C. º8334}; Federal Employees' Retirement System Act of 1986, as amended {5 U.S.C. º8423}; Social Security Act, as amended {26 U.S.C. ºº3101, 3121 and 42 U.S.C. º430}; Federal Employees Health Benefits Act of 1959, as amended {5 U.S.C. ºº8905, 8906, 8909}; and Federal Employees' Group Life Insurance Act of 1980 { U.S.C. º8701}, and (8) tested whether IRS' financial management systems comply with FFMIA requirements, using the implementation guidance in OMB Bulletin 98-08, as amended.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on internal controls. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected.

As the auditor of IRS' financial statements, we are reporting under FFMIA on whether IRS' financial management systems substantially comply with the Federal Financial Management Systems Requirements, applicable federal accounting standards, and the U.S. Standard General Ledger at the transaction level. In making this report, we considered the implementation guidance for FFMIA issued by OMB in Bulletin 98-08, as amended, Audit Requirements for Federal Financial Statements.

We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those required by OMB under Bulletin 98-08, as amended, and which we deemed applicable to the financial statements of IRS for the fiscal year ended September 30, 1999. We did not test compliance with the Antideficiency Act, as amended, due to limitations on the scope of our work discussed in other sections of this report. We caution that noncompliance other than that discussed in this report may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

Except for the limitations on the scope of our work on the financial statements described above, we performed our work in accordance with generally accepted government auditing standards and OMB Bulletin 98-08, as amended.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of this report, IRS stated that it was generally accurate and acknowledged many of the issues, concerns, and internal control weaknesses raised in the report. More importantly, IRS reiterated its commitment to address these issues. IRS pointed out the progress it has made during fiscal year 1999 to address a number of issues from prior audits. For example, IRS noted that it had improved the process for extracting data from its systems on tax revenue related activities and in fiscal year 1999 assumed more responsibility for developing the estimate of taxes receivable appearing on its balance sheet. IRS also noted that it reconciled its fund balance with Treasury at the end of the fiscal year, that monthly reconciliations for the first

2 months of fiscal year 2000 have already been performed, and that a permanent team has been established to ensure that these reconciliations occur routinely. Additionally, IRS noted it has made substantial improvements in clearing out items in its suspense account, is working to develop subsidiary ledgers for its administrative accounts, and has put into place procedures to sustain its property and equipment valuation going forward. At the same time, IRS noted that many of the solutions to its financial management issues can only be found in new or enhanced automated systems and that this will take a number of years to achieve.

We agree that IRS has made progress in the past year to address the difficult challenges that the agency continues to face and commend IRS for the improvements it has made this past year. At the same time, much remains to be done to build on the IRS' fiscal year 1999 successes in order to fully address the pervasive systems and internal control weaknesses we have been reporting each year since we first attempted to audit IRS' financial statements in fiscal year 1992. Most importantly, IRS still lacks the timely and reliable financial and performance information it needs to make decisions on an ongoing basis and to assist it in effectively fulfilling its responsibilities as the nation's tax collector. Some of the issues IRS continues to face can be addressed in the near term with the continued efforts and commitment of IRS management. Others, as IRS noted, involve the modernization of its financial and operational systems and will require years to fully address.

We are committed to continue working together with IRS to address its long-standing financial management and other operational challenges. We have committed substantial time, effort, and resources over the years to working with IRS to help improve the reliability of the information it reports in its financial statements, such as information on taxes receivable and other unpaid assessments, as well as to identify actions needed to produce lasting financial management and operational changes within the agency.

IRS had several other specific comments to the draft of this report. These comments have been incorporated where appropriate.

David M. Walker
Comptroller General
of the United States
February 9, 2000

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

February 22, 2000

Mr. David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

Thank you for the opportunity to comment on your draft report entitled, IRS' Fiscal Year 1999 Financial Statements. We are pleased that, due to our combined IRS and GAO efforts, you once again rendered and unqualified opinion on the IRS' Statement of Custodial Activity. Our unwavering and intense efforts over the past several years resulted in a clean opinion on the $1.9 trillion that IRS collected in tax revenues last year. We are obviously disappointed that we were unable to receive an unqualified opinion for our Administrative accounts, but I trust that you agree that the IRS staff made great strides from the unacceptable situation we found ourselves in at the end of FY 1998.

We also understand that much of your success came through labor intensive processes. We appreciate the cooperative nature of the assistance that we received from the GAO teams to make this approach possible. However, until we are able to replace the legacy data systems now in use, we must perfect and continuer to use these procedures.

Generally, we believe that the report is accurate; however, there is concern in the report about IRS' use of "compensating workarounds." We understand that concern, but with the improvements that were made during the past year (noted in the enclosure), we believe that we cans sustain our progress while seeking more fundamental system improvements. There is a basis, in fact, for a positive outlook in this matter.

We prepared a number of page-by-page comments, which are enclosed, to address many issues contained in your report. We listed the corrective actions taken on the material weaknesses/reportable conditions/noncompliance with laws and regulations as well as other significant matters. We request that these comments be considered as an integral part of this response and that they be included in your final report. We believe that these comments are important to understanding the extent of our efforts and our commitment to further improvement.

During FY 1999, IRS worked hard to improve its financial management reports. Many of the actions resulted from our agreement with your findings in past years. i would like to list a few of the particular items. We overcame the loss of CFO managers that occurred two years ago; our new team of supervisors is now in place. On the Custodial side, we improved our data extract process, and in 1999, we were able to assume responsibility for analysis of the financial classifications for accounts receivable. We were also able to perform collectability analysis of receivables - work that the GAO teams had done until IRS staff was capable of taking over the task.

On the Administrative side the fund balance was reconciled with Treasury at the end of FY 1999, and the monthly reconciliations have now occurred for October and November of FY 2000. A new permanent team is now changed with the function on a recurring basis. The IRS cleaned up the suspense account to a reasonable level, and the appropriate entries were made to record the "clean out" of the account. We are also working to provide a subsidiary ledger to our accounts, which will enable us to give the GAO "cleaner" extracts for audit purposes in the future. In addition, we put into effect procedures that the IRS will follow to ensure sustainability of our property valuation figure from the end of FY 1999. This process will remain in place until a more permanent solution can be achieved.

We view these steps, and numerous others, as necessary investments by IRS to meet the statutory and policy requirements for good financial data that fairly presents the status of IRS finances to all interested parties. We did this to the best of our ability in FY 1999, and we will continue to do so from here on. At the same time, I also need to stress that many of the solutions to the IRS' problems can only be found in new or enhanced automated systems and that this will take a number of years to bring on-line.

In the interim, we intend to develop the best financial data possible, while continuing to concentrate on the more complete reform of the data systems. As the designated official under the Federal Financial Management Improvement Act responsible for the continuity of this effort, I can assure you that we will sustain this year's improvements. We will simultaneously work toward a financial management system that fulfills the requirements of the various acts and also provides IRS managers with the data they need to operate the agency effectively.

We are enclosing a more detailed response to some specific items in the report. I would welcome an opportunity to discuss them with you or the GAO staff. You may also direct any questions you have to the Acting CFO, Larry Rogers.

Sincerely,

Bob Wenzel

Bob Wenzel
Deputy Commissioner Operations

Page 1, fifth paragraph, second sentence

GAO points out that IRS must rely on compensating processes to work around systems and control weaknesses. The specific aim of IRS is to achieve an auditable set of financial data in the immediate years ahead while facing the overall problems associated with retooling the very complex record keeping systems that currently exist for tax administration. It is true that the compensating processes are labor intensive. However, it has been clear for some time, and we have indicated this to GAO and the Congress in previous audit responses, that the ultimate solution lies some years away. Meanwhile, we believe that the emphasis by Congress and the Administration to produce financial data that fairly presents the financial position of IRS each year is extremely important. Therefore, we see many of the following steps taken in
FY 99 as not only related to the current year's audit, but as an interim investment to produce reliable information while building for the longer-term solutions to the IRS financial systems issues.

The following steps taken are:

1. Research and development to produce data extracts for both the custodial and administrative sides. The same data format will be used for the FY 2000 audit.
2. Clean up of the suspense account to bring it to a normal working level.
3. Fund balance reconciliation. Subsequent months since September 30, 1999, have been reconciled (October and November, with December to start shortly).
4. Property and equipment valuation by KPMG. This provided a baseline for an interim property management procedure.
5. A comprehensive set of policies and procedures for custodial financial statements.
6. Detailed ledger for undelivered orders & accounts payable for FY 2000.
7. Plans for a comprehensive replacement of the legacy financial systems environment with an integrated financial management system.
8. Field instructions on file management of assessments and record retention criteria.
9. Nationwide conference/training session for key staffers to develop common understanding of documentation required to support unpaid assessments.
10. Field Instructions that required service centers to report Trust Fund Recovery Penalty (TRFP) transcript inventories.
11. Standards for service centers to certify that TFRP transcripts are not backlogged (greater than 45 days). This is also being done in FY 2000 for the first and third quarter (older than 30 days).
12. Subjected paper returns with Earned Income Credit to fraud detection analysis.
13. Education and outreach measures, including the 2000 EITC return preparer strategy.
14. Redesigned key Earned Income Tax Credit (EITC) publications, forms, and instructions to help prevent overclaims.
15. Worked 70 percent of EITC examinations pre-refund rather than post-refund.
16. Improved screening criteria to minimize erroneous refunds.
17. Implemented an aggressive security management program, which focuses on identifying, managing and mitigating security weaknesses.
18. Numerous substantial improvements to the Excise Tax distribution process.

Page 4, fourth paragraph, first sentence

GAO believes that customer service and compliance programs are intermingled in our statement of net cost. This is because IRS includes funding for what are, in GAO's opinion, customer service activities such as taxpayer walk-in service and taxpayer education efforts in its compliance activities and, because funding for customer service includes funding for personnel in correspondence examination and telephone tax collections. The realignment of these activities occurred in FY 1997 and 1998. These changes were documented in the President's budget submitted to Congress. The budget activity for Customer Service explicitly includes functions that have traditionally been regarded in the past as Compliance. These include telephone collection and correspondence examinations. The reporting under Customer Service is consistent with the way the budget was constructed and presented to Congress. The realignment of walk-in and taxpayer education under Compliance occurred to conform to our internal management structure.

Based on feedback from you and others we appreciate that this realignment has been confusing to some. In the new organizational structure, we are addressing this issue. We plan to manage and report all post filing activities as compliance activities.

Page five, first bullet

The discussion might imply that the IRS has not posted money paid by taxpayers to their accounts, when actually, it is the cross-reference credit that is not posted to the related officers' accounts. We suggest the following revision:

"During our audit we found:

Significant delays – in some instances in excess of 10 years – for the IRS to have posted a cross-reference credit to reduce the related taxpayer account for a payment made by a related taxpayer for a trust fund recovery penalty assessment. We also found instances where cross-reference credits have never been recorded to the related taxpayer accounts for the payments that were made by the related taxpayers. Some of these delayed or unrecorded transactions were made in the late 1980s."

The last sentence of the paragraph beginning on page 14 provides that we have limited success in reducing the extent of inaccuracies in taxpayer accounts. We appreciate your acknowledgement of the steps we have taken to mitigate the lack of an automated link between the systems. We are further enhancing the process in place during your audit, with additional automation of the cross- reference of the assessment and payment processes. However, the most reliable method for correcting this will only be available when we have accomplished our long-term system replacement.

Page 6, paragraph two, first sentence

GAO states that, "We have identified many instances in which accounts that appeared to have some collection potential were not being actively pursued. These accounts had been designated by IRS as "currently not collectible."

IRS' decision to modify the criteria under which unpaid assessments could be designated as "currently not collectible" was resource driven. We are not able to actively pursue these cases with currently available resources. We prioritized our work to address the most current "high dollar" cases, which show the greatest potential for collection. We believe this is a sound business decision and is one of the tools that we use to manage our inventory.

Page seven, paragraph one, first sentence

GAO states that the matching of W-2s and information reporting does not occur at the time the returns are processed because it is not practical due to the intensive labor involved and it would adversely affect the IRS' ability to promptly process tax returns and issue refunds in the interest-free period of 45 days. This is a correct statement. However, for correct presentation of this issue, we believe that a change is necessary to your comments on this issue. We believe that a more effective control is to match the third party information received independent of the tax payers submissions. Existing law controls our short or long term ability to implement this change. Taxpayers can begin to file their returns in January of the year following the close of their tax year. The law permits providers of forms W-2 and other information reports until the end of February to submit the information to us. Beginning in 2000, RRA 98 granted taxpayers an additional month for filing W-2's and other information returns if these documents are filed electronically. To delay the processing of returns until the W-2s and information reports are received would be inconsistent with our mission of service to taxpayers. The statutory time frames inhibit our ability to implement this recommendation without a concomitant change in the tax law.

This additional time inhibits our ability to implement GAO's recommendation as a long-term solution.

Page 7, middle of 2nd paragraph, fifth sentence should be corrected

The draft report states that Earned Income Tax Credit examinations are "…often performed after any related refunds are disbursed, examinations cannot substitute for effective controls…"

We do freeze refunds for those taxpayers whose returns have the greatest potential for being invalid. We perform more pre-refund than post-refund audits. Of the 573,000 tax returns examined in FY 1999, approximately 70 percent were pre-refund audits. In other words, we examined tax returns before issuing refunds in over 400,000 of the EITC returns examined last year. An example of a return receiving post-refund audit treatment would be one where more than one taxpayer is claiming the same qualifying child for EITC. At the conclusion of the audit, the taxpayer who is not entitled to the credit is billed for the overpayment and the taxpayer's file is marked so that EITC cannot be claimed in a subsequent year without the taxpayer re-certifying eligibility for the credit. For the 2001 filing season, we plan to have the Dependent Database match in place, that will allow us to perform pre-refund audits of these duplicate Taxpayer Identification Number (TIN) cases.

Page 8, third paragraph, first sentence

During the last quarter of fiscal year 1999, IRS undertook an intense and thorough effort to reconcile its Fund Balance to Treasury's records. Due to compressed time frames, IRS delivered reconciliation schedules as they were completed, per agreement with GAO staff. We recognize that this approach may have complicated GAO's audit work. However, we would like to clarify that by the end of IRS' effort, no reconciliation schedules were omitted or contained errors of any substance identified by GAO.

Further, we disagree with GAO's use of the term "unsupported" when referring to the payroll reconciling items. In its Matter for Further Consideration (MFC #406) on this issue GAO stated, "Subsequently, IRS provided documentation that verified that the differences are related to payroll transactions…"(Copy enclosed for your reference).

Another clarification should be made in the report when GAO states that, "IRS' lack of routine and complete reconciliation raise serious concerns about its ongoing ability to ensure that it complies with laws…" We accept this as an accurate report of past practice. However, a monthly reconciliation process and additional internal controls have been established as part of fiscal year end 1999 comprehensive effort. Since the end of fiscal year 1999, reconciliation has been completed for October and November of FY 2000, with December reconciliation currently in progress. The effort to correct the fund balance and the underlying process for recurring monthly reconciliation is completely supported at the senior executive level at IRS.

Page 9, First paragraph, second sentence

"IRS relies on individuals across the country to inform those responsible for maintaining the subsidiary records of any Property and Equipment (P&E) additions or disposals."

This fairly characterizes problems related to the current system of property and equipment inventories. However, during this audit period, and as part of the decision to have a one-time valuation of P&E done by a contractor, IRS has reviewed its efforts to improve and maintain a good property management system. Immediately ahead, there is an internal procedure to maintain the benchmark from the sample valuation done for September 30, 1999. Later, through the implementation of the Single Point Inventory Function (SPIF) we will have teams on site in field locations to review procurements on Requisition Tracking System (RTS), ensure their delivery on site, and insure proper disposition and removal from inventory system. The SPIF procedure will be used to improve both Integrated Network and Operations Management System

(INOMS) and Property Asset Tracking System (PATS), and will continue in place until an integrated property management system is installed as the overall financial management system is replaced.

Page 9, First paragraph, ninth sentence

"We found valuation errors in IRS' records including a Compaq laptop computer recorded at a cost of $310,000 and a copy of Microsoft Office software that cost $212 but was erroneously recorded at $212,000." Exception reviews built into the MOU (see item above) will prevent this type of input error in the short run. With implementation of the SPIF teams, only a limited number of employees will have the ability to input information into INOMS and PATS. This will limit the potential for keystroke errors. In addition, quality review processes will be implemented to ensure the accuracy of the information in INOMS and PATS.
Page nine, third paragraph, fourth sentence

A specific comment is being made that, "If IRS does not implement needed improvements for fiscal year 2000, it will have spent millions of dollars on an estimate that was reliable for only one day…"

The cost to develop the sample was $74,922.51. The cost to implement the sample was $1,492,961.00 (a total of $1,567,883.51), not the "millions of dollars" as stated in the report. Additionally, the Asset Management Modernization Project Office will use this comprehensive inventory as the baseline for the new ADP inventory system. The Single Point Inventory Function (SPIF) will be implemented in 2001. In the interim, CIO is working with the CFO and the Procurement Office to capture and correctly record all capital assets. Capital assets will be tracked throughout their life cycle (purchasing through disposal). The IRS is committed to developing a workable and reliable asset management program.

Page 10, second paragraph, seventh sentence

Some additional facts affecting resolving some suspense account charges:

1 Online Payment and Collections (OPAC) charges to IRS amount to more than $1 billion annually. All but 1 percent was posted to an obligation at FYE 1999.
2 GAO selected a non-statistical sample of 10 items from the suspense account log as of September 30, 1999. All 10 items were charges from GSA, a mandatory service provider we continually have difficulty getting supporting documentation from for charges, as we presume other government agencies do as well.

As we have indicated in the past much of the suspense account issue is related to the OPAC process in which another federal entity can reduce your "bank account balance" and not give you sufficient documentation explaining why they did it. This is similar to having your credit card bank pay themselves directly from your bank account without having to send the details of the charges. The IRS must then expend enormous resources tracking down this information. We understand this to be a government-wide problem that requires cooperation from all federal entities to resolve. IRS requests that GAO provide a more detailed explanation in the report of the OPAC process and the reasons an agency would need to post to a suspense account.

Page 10, first paragraph, first sentence

GAO information related to Automated Financial System (AFS) users should be revised to reflect that there are 1,777 users and of that 438 (or 24 percent) have the ability to affect spending. However, another individual is required to approve these transactions prior to recording the expense. In addition, 45 of the 1,777 users (2.5 percent) have the ability to override spending controls that exceed the amounts appropriated. These individuals consist of:

1. National Office Budget Division personnel (24)
2. Systems and Accounting Standards personnel (21)

We have corrected profiles for 32 users who were erroneously placed on National Office Budget profiles. We have also completed an analysis that determined that the Budget Division would continue to need 24 users with override capability and 10 Systems and Accounting Standards personnel. Our analysis determined that there should be 11 AFS users with the highest override category. Therefore, the number of individuals being allowed the capability to override has decreased.

Page 12, first paragraph, third sentence

With regard to the excise tax distribution process, we would like to point out that as GAO states in both their FY 1998 financial audit, IRS is dependent on a "complex, error-prone process for determining revenue distributions." They also reiterated a similar comment in the FY 1999 financial audit. This is the case, as taxpayers are required to remit payments earlier than they are either able or required to remit assessment information.

In GAO's discussion of the reporting and distribution to trust funds for this fiscal year, it is important to recognize the IRS' efforts to attain more accurate data. Within FY 1999, the IRS added two additional analysts to support the review/certification process of excise taxes. Check sheets (which are subject to managerial review/approval) have been developed to ensure the quality of each excise tax certification. Procedures were established to provide post-input controls to review certain returns with assessments of $1M and over and all returns reporting coal tax assessments of $500K. This means that the IRS is reviewing over 92 percent of the total dollar value of excise tax assessments.

We also wish to state that in June 1998, IRS changed from certifying based on liabilities to certifying based on collections, making it important that tax returns post timely to ensure the accuracy of the certified amounts. To address GAO's concerns regarding amounts reported from previous quarters in current quarter certifications, the IRS revised its procedures to ensure expedited posting of the returns. These procedures have resulted in significant improvements; however, the reporting from previous quarters will continue to occur because of amended returns, audits and late filing of returns subsequent to the certification period. Additionally, there is currently no penalty for filing a late return if the taxpayer makes timely deposits, although we continue to monitor these taxpayers and request their returns.

Page 13, first paragraph, first sentence

IRS would like to clarify GAO's statements related to installment agreements.

The Assistant Commissioner (Collection) issued a memorandum in March 1998 that stated that any new installment agreement given to a taxpayer must provide for full satisfaction of the taxpayer's liability. Fully satisfying the liability during the term of the agreement had not been part of our long-time interpretation of the Internal Revenue Code (IRC). Prior to the March 1998 memorandum, employees were in compliance with existing procedures. The revised procedures prohibit entering into an installment agreement that does not fully satisfy the liability over the term of the agreement. The post memorandum non-compliance reflects errors occurring during transition to a new procedure. In addition to the memorandum that was issued providing instructions, the IRM was subsequently revised to include this change in procedure.

Page 13, third paragraph, first sentence

GAO states that, "…IRS did not release the applicable federal tax lien within the 30-day requirement stipulated in the Internal Revenue Code."

The Automated Lien System (ALS) provides for the systemic release of liens when the account is fully satisfied or is no longer enforceable (by reason of lapse of time.) To ensure all liens are released timely, effective January 2000, we have developed an enhancement to the system that reviews all accounts a second time to ensure that all liens that require release have been identified and released by ALS.

GAO COMMENTS

The following are GAO's comments on the IRS' letter dated February 22, 2000.

1 While we agree, we wish to clarify one comment. This pertains to IRS' reference to its having assumed responsibility for analyzing (1) classifications of its unpaid assessments and (2) the collectibility for those unpaid assessments determined to be taxes receivable. IRS personnel did, in fact, assume more of the responsibility for the initial review of the sample of unpaid assessment cases to determine this year's projected balance of net taxes receivable. However, it is important to note that this was just one aspect in the development of the net taxes receivable balance appearing in the financial statements. As we have in the past 2 years, we continue to develop the overall sampling design and approach, analyze the sample results, and project these results out to the year-end balance of the unpaid assessments inventory. Additionally, we worked extensively with IRS personnel in reviewing the detailed sample cases to arrive at appropriate conclusions with regard to their proper classification and, for taxes receivable sample items, their appropriate collectibility potential.

2 We agree. However, budgetary presentation and organizational structure do not affect IRS' responsibility to classify its costs in a manner consistent with the related descriptions on the face of its financial statements and in related performance measures. We believe that users of IRS' financial statements and performance information will view taxpayer walk-in and education efforts as forms of customer service and will consider telephone collections and correspondence examinations to be forms of compliance. To the extent related costs are classified otherwise, we believe the users of IRS' financial statements and related performance information will be misled about the level of costs IRS is incurring for each of these activities. We are encouraged by IRS' comments on this matter and will follow up on this issue as part of our audit of IRS' fiscal year 2000 financial statements.

3 We agree in part with the IRS' suggested revisions and have revised the second sentence in this section accordingly. However, further clarification was already contained in the paragraph immediately following the bullets.

4 We disagree. We believe that the presentation of this issue in our report is accurate. We continue to identify weaknesses in IRS' preventive controls over refunds that increase the risk that inappropriate refunds will be disbursed.

5 We agree. However, IRS' letter indicates that about 30 percent, or about 171,900 of the 573,000 EITC examinations performed in fiscal year 1999, took place after the refund was issued. This is consistent with the statement in our report that examinations of EITC often occur after the related refunds are disbursed and cannot, therefore, serve as a substitute for effective preventive controls.

6 We disagree. IRS is correct in noting that we concurred that the remaining reconciling items pertain to payroll differences. However, these are considered unsupported reconciling items because, at the time we completed our audit field work, IRS had yet to determine the extent to which its records, Treasury's records, or some combination of the two required further adjustments for these differences. Had these items been supported, IRS would have been able to adjust its records or communicate to Treasury the needed adjustments to Treasury's records. Resolution of differences is an integral part of the reconciliation process.

7 We have received a copy of a memorandum of understanding between IRS' Chief Financial Officer, Chief Information Officer, and Chief, Agency-wide Shared Services, called "Capitalized Property Tracking" that outlines the responsibilities of each party in this area. We have not seen any information on what the IRS refers to as the "Single Point Inventory Function (SPIF)." Additionally, to date we have seen no evidence of concurrence with this memorandum between the key individuals responsible for complying with its requirements. Also, a formal memorandum, in and of itself, is not sufficient to ensure that IRS adheres to such requirements. We will assess whether these and other plans will resolve IRS' long-standing problems in the area of property and equipment and the related recording of program expenses as part of our fiscal year 2000 financial audit.

8 IRS points out in its comments that the cost to develop and implement the property and equipment sample was $1,567,883.51, not the "millions of dollars" as stated in the report. We disagree that this is the full cost of the sample. Specifically, this cost excludes the significant time and effort spent by IRS staff at 15 locations across the country to assist the consultants in planning for and executing this sample. However, because IRS does not know what the full cost of this effort was, we have revised our report to say "over $1 million."

We also disagree with IRS' characterization of this effort as a "comprehensive inventory." As we reported, this effort was a statistical estimate of IRS' property and equipment balance at September 30, 1999. IRS' underlying records at September 30, 1999, were unreliable. Thus, when IRS notes that it will "maintain the benchmark," we believe this means that they plan to keep reliable, transaction-based records beginning October 1, 1999. The result of the statistical estimation is an aggregate estimate of property and equipment that will be depreciated in bulk in future years until all components of the estimate are fully depreciated. It is also important to note that if IRS is not successful in its plans to keep reliable, transaction-based records for fiscal year 2000, the benefits of the over $1 million spent on the statistical estimate will not be realized.

9 A more detailed explanation of the OPAC process is not necessary. As IRS acknowledged in its own comments, it has difficulty getting documentation supporting these OPAC charges. Without adequate documentation, the use of a suspense account is a standard accounting practice. As stated in the report, IRS needs to research and clear these accounts as promptly as possible.

10 We are unaware of the reason for the differences between the information provided in IRS' letter and our report. We will follow up on this issue during our fiscal year 2000 audit in order to resolve these questions and to assess the appropriateness of the changes in override capabilities discussed in IRS' letter.

11 We agree. However, as stated in our report, we continued to find errors in IRS' excise tax certification process that were not caught and corrected in time to prevent them from adversely affecting trust fund distributions. This indicates that the enhancements IRS made to its certification process in fiscal year 1999 were not always effective in identifying and correcting errors in a timely manner.

12 We agree with IRS that the instances of noncompliance related to installment agreements reflect errors occurring during the transition to a new procedure. However, as we have seen over the years of auditing IRS, the issuance of a memorandum is not in and of itself a control. IRS has issued policy memoranda for many of the control problems noted in this report. We have found that without controls to ensure compliance with policy, problems have persisted in areas such as property and equipment and the handling of hardcopy taxpayer receipts and data. The key to enforcement of policies is the implementation of effective internal controls. If IRS continues to encounter installment agreements that fail to comply with this memorandum, it may be necessary to implement internal controls as a means to enforce the policy described in the memorandum.

13 We will follow up during our fiscal year 2000 audit to assess the effectiveness of the enhanced Automated Lien System in ensuring that liens are released in accordance with the Internal Revenue Code.

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